EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

NOVEMBER 2015

THE ALPHA CYCLE

The defining aspect of the Coronation investment philosophy is our commitment to the long term. Where many other managers may be under pressure to perform well over twelve months, we invest with a time horizon of five years and longer, which allows us to invest in assets that we believe are trading at substantial discounts to our assessment of their underlying long-term value.

In the late stages of trending markets, portfolios often include assets shunned by other investors. As has been seen many times throughout our history, this results in short-term underperformance. In 2001, when the rand blew out to R20 to the pound and South Africans were frantically moving money offshore and buying rand-hedge stocks at any price, we took a long-term view and started selling those stocks, while buying unpopular domestic shares. Although this decision caused short-term underperformance, it added significant value to our portfolios over time. (Those who exchanged rands for pounds in December 2001 had to wait another 14 years to recover their subsequent currency losses.) In 2004, we again went against market trend and sold hot domestic stocks, in order to protect our long-term investors against the subsequent correction. Four years later, we did not invest in construction shares even as the sector exploded amid excitement about multi-decade infrastructure expenditure.

Again and again, investing with a five to ten-year time horizon has kept us out of trouble. Other examples of these forward-looking decisions underpinning our investment track record include:

- Selling commodity stocks towards the end of the "super-cycle" (2008).
- Aggressive buying of equities during the global financial crisis (2008/9)
- Selling bonds into the fear trade amid the global financial crisis (2008)
- Aggressive buying of offshore equities when the rand was strong and domestic stocks were flying (2010/11)

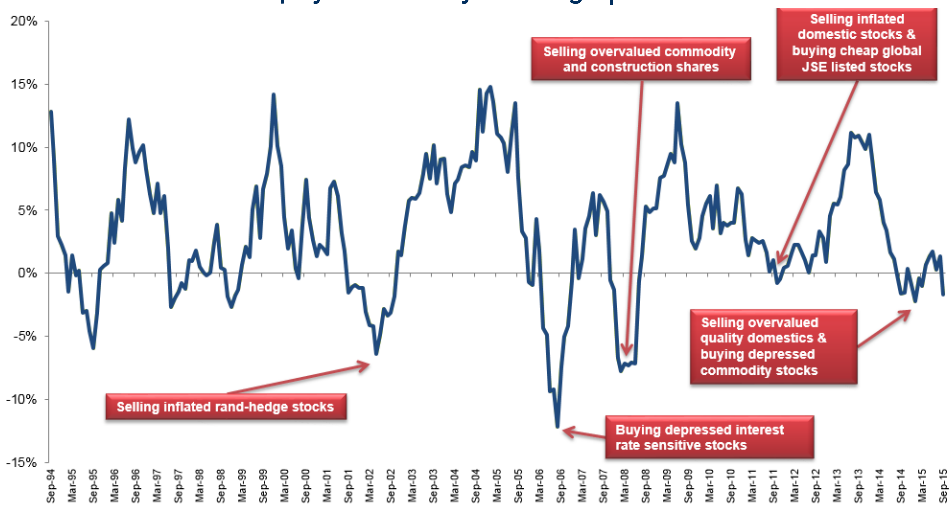
Outside of income and growth funds, we are indifferent to performance over periods of less than five years. This is why we are ardent proponents of split funding. We believe the maximum exposure to any one fund manager should be 30% of a client portfolio. This is more likely to be a sustainable allocation that will better allow our clients to stand behind us through a cycle. If you are overexposed to a single fund manager, you will not be able to hold that exposure following a bad year – the pressure from clients will be too much. You will be forced to cut exposure, and very likely at exactly the wrong time; increasing your client's exposure to funds that have enjoyed a good couple of years while cutting exposure to those that have just had some bad years. In investments you want to buy low, sell high - not chase yesterday's winners. We encourage investors to judge us over meaningful periods. The chart below shows that investors who share our long time horizon have seen a steady outperformance of the market ('alpha') over periods of more than five years.

Coronation Houseview Equity Fund – long-term alpha

As at 30 September 2015

However, underpinning this stable long-term outperformance are periods of volatile short-term underperformance. We have endured many such testing periods and we expect to underperform the market, when measured over a 12-month period, in one year out of every three or four. As illustrated in the graph below, which shows alpha over rolling one-year periods, it is in these periods of relative underperformance that we typically make our best investment decisions, which go on to add significant value over time.

Coronation Houseview Equity Fund – one-year rolling alpha



As at 30 September 2015

We are painfully aware that our Capital Plus, Top 20 and Global Managed funds are suffering short-term performance pressure. However, we believe this underperformance may well be an indication that we are making strong decisions that will deliver in the years ahead.

It is easy to put a 'today portfolio' together; simply exclude resources, construction shares and emerging markets. Very few investors can create a 'tomorrow' portfolio, which requires brave, contrarian calls informed by underlying valuations.

Typically, where assets are bought at 'any' price and others are loathed at 'any' price, clients who invest with a manager like Coronation can benefit from taking long-term views and profit from the resulting disconnect between price and value. We are excited about selected opportunities we are finding in the market and expect these views to deliver alpha in future years.

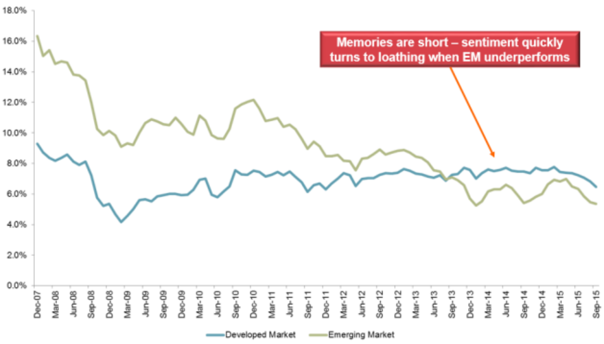
EMERGING MARKETS

Over very long periods of time, emerging markets have done incredibly well for investors. However, these markets are more cyclical than developed markets, and have had a very bad three to four years. Because sentiment is so depressed, we are finding compelling value; high-quality emerging market companies are trading at bargain basement prices. In addition, global fund managers are structurally very underweight emerging markets.

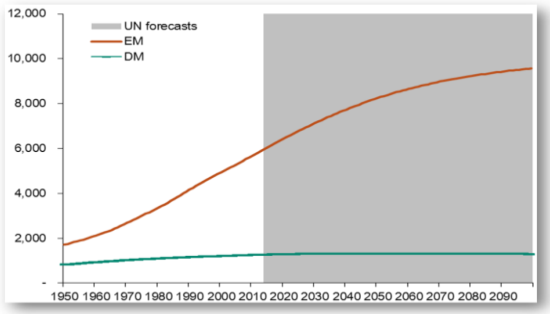
Emerging markets offer great opportunities for a number of reasons, including population growth. Ageing populations are very bad for economic growth and will be a major headwind for most developed market economies.

Developed vs emerging market returns

Rolling 20 years



Population growth



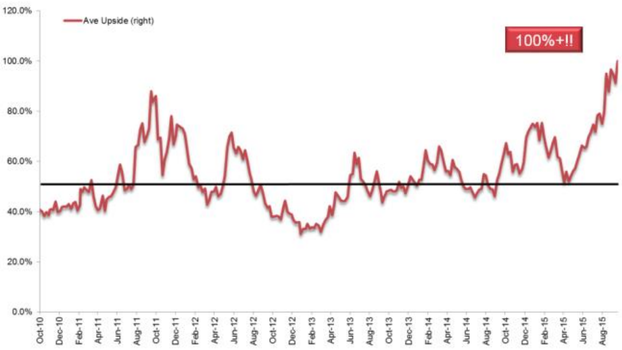
Source: BofA Merrill Lynch Global Investment Strategy, UN Population Database, Haver

We have number of favoured investments in emerging markets, including Kroton, the leader in private education in Brazil, which is trading at less than 10 times forward earnings. The company looks set to continue to benefit from the long-term drivers for the tertiary education sector in Brazil. We are also invested in top Russian food retailers, which offer exceptional businesses with great management teams, and still have significant headroom to grow market share. In India, selected private sector banks offer strong growth in an under-banked market, where credit penetration is very low compared to other countries.

Our estimation of the upside in our emerging market holdings is close to 100% - in other words, the portfolio is worth twice the price we can buy it at today. The last time we had a similar disconnect between price and value, the fund did extremely well in the subsequent years. It is important to note, however, that while we think our selected emerging market holdings offer great opportunities, we understand the cyclicality of lower quality assets, and therefore carefully manage risk and the size of our positions across various fund mandates. For example, the more conservative Capital Plus Fund only has a direct exposure of 1.4% to emerging markets, while Balanced Plus has 7%.

GEM fund estimated average upside

Valuations are compelling



RESOURCES

The outlook for commodities over the next year or two remains very bleak. The big concern is a weaker China, which consumes about half the world's commodities (apart from oil and platinum). Also, the longer-term threats of electric vehicles and renewable energy are gaining traction and, in truth, all fossil-fuel related sectors (oil, thermal coal, PGMs) are now sunset industries. Despite the sharp declines in commodity prices, supply remains sticky given the big barriers to exit in mining. Most commodities remain in oversupply.

Valuations are now very cheap, with quality companies trading at less than half of what they are worth. As a long-term manager, we believe it is the right response to invest in these shares, even though it will result in underperformance over the short term. Still, our positions in resources are not portfolio-defining. Our key objective is to put anti-fragile portfolios together that reflect not only one or two ideas but numerous opportunities. Our Equity Fund only has 14%-exposure to commodities, while Top 20 has 18%, which are comparable to current resource sector index weightings.

Resource valuations at multi-decade lows

World Mining Index Return on Equity relative to World Index

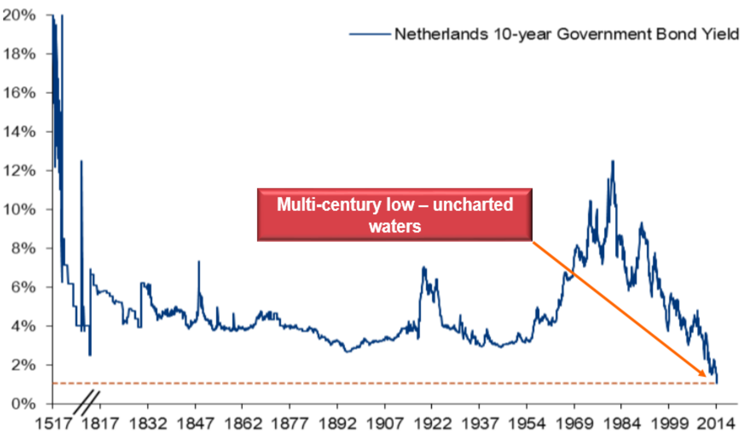
World Mining Index Price-to-Book value relative to World Index

Source: Datastream, Morgan Stanley Research

INVESTMENT PROSPECTS

We have seen a prolonged period of extraordinary investment returns. Following the global financial crisis, policymakers have taken unprecedented action, resulting in zero interest rates in the developed world. Developed market equities have delivered a strong performance despite anaemic economic growth; the dollar has been the only currency to own and a quarter of European bond markets now have negative interest rates, with investors effectively paying governments for the privilege of lending money to them.

Dutch bond yields since 1517



Standard & Poor's 500 index

The great risk is to start believing that this is normal. Markets are now addicted to zero interest rates, and there is a real risk of secular stagnation ('Japanification') if we cannot extricate ourselves from this dangerous situation. Accordingly, our portfolios need to be future-proofed and anti-fragile to handle the unexpected. We will sacrifice short-term performance in return for robust portfolios that can handle the unexpected in the years ahead.

The JSE has been the sixth best performing market (in dollars) in the world over the past fifty years. With an average annual return of 17%, investors doubled their money seven times over the past three decades. Currently, high-quality companies continue to be priced for perfection despite a very troubling domestic background. Electricity is expensive and unreliable, labour is not internationally competitive, most companies are cutting jobs (very negative for consumer demand) and almost all goods-producing firms are asking government for protection. Because of SA's intractable problems, the only release valves are inflation and the rand. Unlike previous overblown rand sell-offs, we believe this time is different; the currency is reflecting the underlying situation and won't help bolster the economy – it is barely keeping firms afloat. As a result, we continue to hold healthy positions in global equities, as well as rand hedge shares.

We also continue to expect lower investment returns from all asset classes in coming years, as detailed in the table below. In the strong markets of recent years, good advisors and good fund managers were a nice-to-have, not a must-have. In the expected environment of high inflation and low nominal returns, good advisors and fund managers will become a must-have, and can add enormous value. Advisors can assist investors by ensuring judicious drawdown levels, allocating to the right fund managers for the right reasons and investing for the long term; churning nearly always results in buying high and selling low.

Expected asset class returns

	Last 10 years (ZAR)	10 year forecast (ZAR)
Local equity	15.5%	7 – 10%
Global equity	13.9%	8 – 11%
Local property	19.4%	7 - 10%
Local bonds	8.2%	8 – 9%
Global bonds	11.8%	4 - 6%
Cash	7.5%	7 – 8%
Inflation	6.1%	6 – 7%

as at 30 September 2015

IS CORONATION TOO LARGE TO DELIVER?

We are often asked whether our size will impact our investment performance. This is not something we worry about, for a number of reasons:

- Coronation has never been a small manager. From our launch, we attracted large and meaningful assets and were included in the Alexander Forbes Large Manager Watch™ survey early in our history. Unlike small managers who struggle to maintain their performance when they grow larger, our track record is not based on investing in small and mid cap stocks, but on making the correct decisions about large holdings.
- In the concentrated SA market, all managers need to get the same big calls right. In a market where five companies make up 40% of the FTSE/JSE Capped Index (CAPI), all managers have to get these big shares right. Outperformance in smaller companies alone will not help you beat the market.
- Size actually helps in many ways; by forcing us to focus on the long term and allowing us to invest in the best resources and people to secure a deep knowledge of industries and asset classes across the world.

- We also believe we closed our institutional book in time, which represents two-thirds of the assets we manage. Despite growth in some of our retail funds, our total asset base is shrinking, which will keep our share of the market below 4% of the JSE.

For a detailed analysis of the size debate, please refer to the September issue of *Corospondent*.

RETAIL DISTRIBUTION REVIEW

The Retail Distribution Review (RDR) may largely be a non-event for truly independent investment-focused advisors. Its key objective – eliminating conflicts of interest in advisor remuneration – is widely accepted in the SA investment market. The authorities have also accepted industry's own solution to the conflict problem: a platform administering an advice fee agreed upon between the advisor and the client. Much has been made about the impact of the RDR in the UK, and the fact that 25% of advisors exited that market following its implementation. However, its RDR process introduced a professionalisation of advice which has already been underway in South Africa since 2002, with the introduction of the FAIS Act. The UK RDR also included the introduction of exams, which are already part of the SA landscape. In addition, the UK advisor numbers were affected by 'high street banks' exiting the advice business for reasons more related to the fall-out of tax-payer support following the global financial crisis.

The RDR's regulatory goal is to help clients understand whether there may be a bias in the advice they receive, enabling them to better make the appropriate trade-offs. Independent advisors offer the benefit of providing unbiased advice as they are completely separate from any product supplier. The latter does not have links with, or influence over, the advisor. In turn, a tied advisor has some relationship with the product supplier, and offers the client recourse from a big brand in case something goes wrong. Some clients will prefer the comfort of dealing with a large company who backs the advice. Others will prefer dealing with smaller advisors who may not have the deep pockets of large institutions, but can offer advice using objective criteria.

Surveys confirm that the vast majority of clients are happy with their advisor, although they do not clearly understand how and what they pay for advice. Clients want advisors with a good reputation, who have integrity and are trustworthy. They require good communication and effective management of expectations, as well as knowledge and experience; actionable recommendations about what to do, and simple ways of getting it done. Affluent clients place the highest value on independence. Clients who clearly understand what they pay for advice will accept a premium for independent advice supported by appropriate expertise.

We strongly believe there should only be two categories of advisors: independent advisors, who are not influenced by product suppliers, versus tied advisors, where one or multiple suppliers exercise influence over the advisor, or vice versa. Furthermore, it remains our view that clients may be best served by unbiased advisors holding independent fund managers to account. In fact, the RDR may help advisors by addressing the problem of accountability when investment outcomes disappoint. Currently, if an advisor's clients are unhappy with an outcome their only recourse is to submit a complaint to the FAIS Ombud; there is no resolution mechanism for investment products. Consequently, every issue starts looking like an advice problem. In future, the accountability will be shared by tied advisors and their associated product suppliers, while independent advisors will only be responsible for their own actions.

Unfortunately, the RDR is misrepresented to scare advisors into abandoning their current approach to managing their practice and investments. For example, it is a fallacy that the RDR will require advisors to adopt formal multi-management or investment consulting. Some fearmongering parties are claiming that FAIS Category I advisors, who implement fund selection themselves, may cause poor client outcomes, and a Category II advisor should instead be appointed to assist with running model portfolios, which will ensure that all similar clients enjoy the same outcomes. The unstated implication is that you can only defend the outcomes of the advice process if all clients get the same solutions. However, this cannot be reconciled with personalised advice and begs the question why the regulator would then grant Category I licenses. The regulator cannot discriminate on the grounds of licence constraints, as implemented by the same regulator. Further, the selection of a multi-manager may create a tied relationship with a product supplier. Importantly, there is no historical evidence that formal multi-managed solutions offer better outcomes than a simple split-funding approach.

TAX OUTLOOK

Higher taxes for savers and investors are very likely, and the Davis commission has indicated that estate duty and trusts, in particular, may be targeted. Advisors can help strengthen trust deeds against these proposed attacks, which are expected to be promulgated from 2017. We expect a tax harmonisation in retirement savings from March 2016, with a R350 000 cap; 27.5% all-in contribution and larger *de minimus* of R247 500 at retirement. Treasury has been successful in normalising provident funds, which unique ability to take the full retirement benefit as a lump sum will be phased out on new contributions for those younger than 55 from 1 March 2016.

RETIREMENT REFORM

Treasury has started consultation on introducing three default requirements for all retirement funds:

- Investment options. The key issues are a proposed ban on products that charge performance fees and a preference for passive investments.
- Preservation. The aim is to let accumulated savings follow members, largely automatically, from fund to fund.
- A default post-retirement income option, plus access to a retirement benefits counsellor.

Consultations are continuing, but there has been resistance from industry as the proposals, which will impact more than 90% of retirement assets, are systemic, go too far too quickly, and will have large unintended consequences.

BUSINESS AND PRODUCT UPDATE

Our fee and benchmark changes, as announced earlier this year, were implemented as planned on 1 October. The mandate change in the Equity Fund enables the fund to have offshore exposure, which will reach 25% by end-December. The newly launched SA Equity Fund is available for investors who do not wish to have global exposure. Following a successful ballot, the Top 20 Fund can now select shares from the entire universe of JSE-listed equities.

The administration of our retirement and endowment products will move to the same administrator who manages our unit trusts from 1 January 2016. This consolidation should assist in enhancing our service to you. As part of the migration, there will be a freeze period from 23 to 31 December on transactions in these products.