OUTLOOK FOR FIXED INCOME

Contrary to many forecasts, 2014 turned out to be a positive year for fixed income assets as market expectations of rising bond yields were confounded. In fact, US bond yields halved in 2014, a year that was characterised by a strong dollar – underpinned by successive quarters of growth and strong labour trends. Meanwhile in Europe, economies faltered and strong disinflationary trends emerged. This prompted a €1.1 trillion bond-buying programme by the European Central Bank at the start of 2015, bolstering liquidity and yields in bond markets.

The developed market bond strength filtered through to emerging markets. While South African bonds started the year on a very weak footing following an interest rate hike in January 2014, a strong rally formed as the global risk premium was repriced.

Strong year for fixed income

SA bonds track global developments

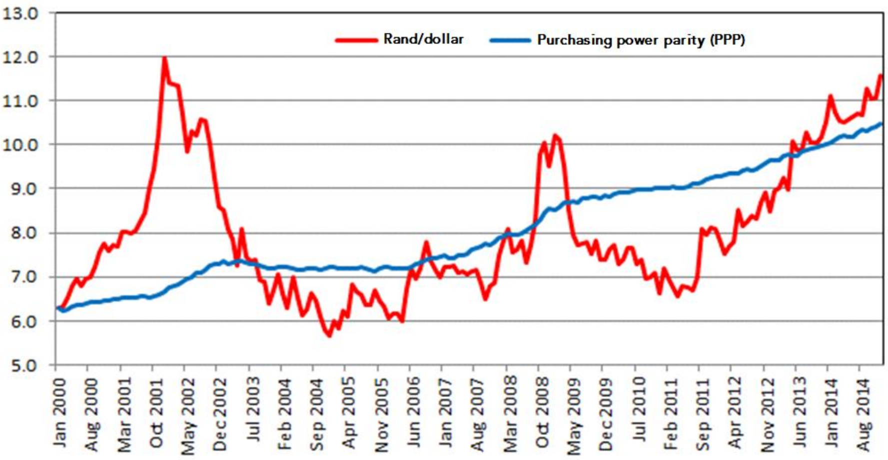
Source: INET

Asset class returns in 2014

Instrument	Return
Cash (STeFi)	5.7%
All Bond Index	10.2%
All Bond Index (1 – 3 years)	6.2%
Barclays government inflation-linked index	11.2%
Preference shares	-5.6%
Listed property	26.6%

Despite this solid performance, foreign selling of domestic bonds reached their highest levels in almost two decades. While some of the outflow was rotated into equities, the selling contributed to a 9%-slide in the rand. Using long-term purchasing power parity (PPP) as a measure, we believe that the rand remains undervalued by ±15% (at current levels). This does not imply an imminent retracing; it can take many years for the rand to converge to fair value.

Rand remains undervalued



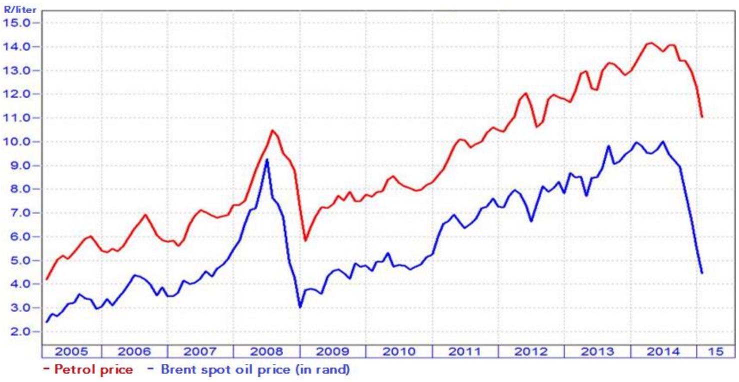
Looking at 2015, it is very hard to predict an equally strong year for the fixed income sector. However, there is much reason to expect a constructive environment for the asset class. The global market is awash with liquidity provided by the European and

Japanese monetary authorities. In addition, the interest rate hiking cycle by the US Federal Reserve may be more muted than expected. This should provide a strong underpin for bonds.

Domestically, South Africa's twin deficit problem could ease as the weak rand and uninterrupted output (following multi-year wage agreements at strike-hit mines and manufacturers) shore up exports. There is also hope that the new finance minister will reinvigorate fiscal consolidation. This could be enforced by the selling of non-core assets (including stakes in Vodacom and Telkom), as well as increases in tax (VAT, personal income tax, a wealth tax or some combination thereof) to bolster revenue.

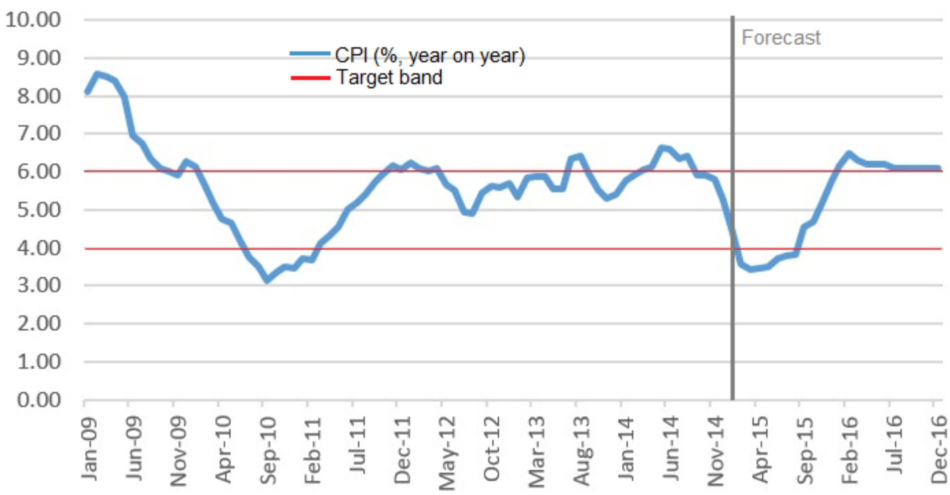
Most importantly, the slump in the oil price has been a game changer. The 60% decline in the rand price of oil over recent months has profoundly moderated inflation forecasts and is taking pressure off the SA Reserve Bank (SARB) to hike rates during this year.

Oil slump



We see CPI moving to just above 3% in the next three months, averaging at just over 4% for the year; well below the midpoint of the SARB's target range. The lower oil price may also have an important impact on growth as it feeds through the supply chain and alleviate pricing pressures. Following a sharp decline in 2014, maize prices have started to rise, which could limit disinflationary gains from food inflation. We expect inflation to rise towards 6% again in 2016 as the positive effects of the oil slump fall away. We still expect interest rates to remain flat for the next twelve months, which will be supportive of fixed income portfolios.

A benign inflation outlook



While the impact of cheaper petrol should be positive, South African economic growth potential remains, at best, fragile. Eskom is a large concern, and the electricity deficit is discouraging new business investments and impeding growth in other ways. In addition, government finances remain at risk. Tax hikes could be supportive, but the real test would be the outcome of public sector wage settlements.

LISTED PROPERTY

The strong bond market supported the listed property sector, which delivered a return of more than 26% in 2014. There is a strong correlation between property yields and bond yields; while historically the correlation was on average 68%, recently it has moved closer to between 80% and 90%. Moreover, the domestic listed property sector has been supported by international interest following the conversion of property companies into real estate investment trusts (REITs) under legislation adopted in 2013. International investors are more comfortable with REITs than with South Africa's previous Property Unit Trust (PUT) and Property Loan Stock (PLS) structures. (With almost twenty new listings since 2011 the sector has seen tremendous growth, reaching a market capitalisation of R400 billion last year – 4% of the JSE, compared to less than 1% in 2002.)

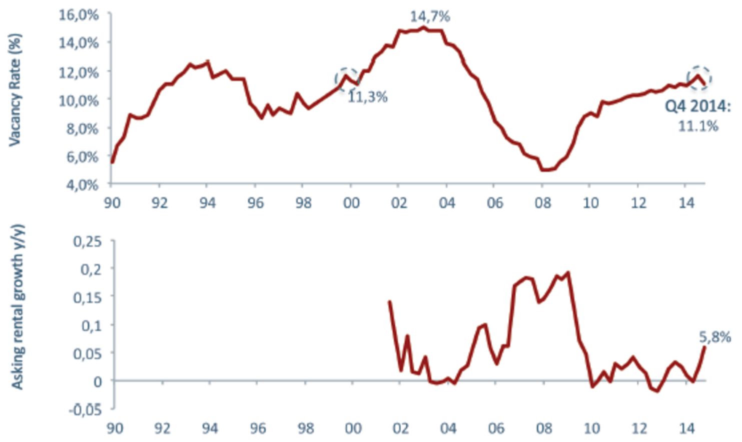
The main driver of the sector's strong performance last year, however, was impressive dividend growth. Most companies surprised on the upside, delivering dividend growth of on average between 10% and 11%.

Dividend growth key component of capital return

		Total return		Capital return	
	Total Return	Income return	Capital return	Return due to bond yield	Return due to dividend growth
2007	26.5%	7.5%	19.0%	5.3%	13.7%
2008	-4.5%	8.0%	-12.5%	-19.4%	6.9%
2009	14.1%	9.7%	4.3%	0.1%	4.2%
2010	29.6%	10.0%	19.6%	14.8%	4.8%
2011	8.9%	8.5%	0.4%	-1.2%	1.7%
2012	35.9%	8.9%	27.0%	17.1%	9.8%
2013	8.4%	6.8%	1.6%	-6.8%	8.3%
2014	26.6%	8.1%	18.6%	8.8%	9.8%

Property companies are traditionally highly geared, and sustained lower interest rates helped to bolster their dividends. Also, vacancies and operating costs were managed well and, for the first time in many years, growth in asking rentals was seen across the board, even in office properties.

Improvement in office sector



Source: South African Property Owners Association

Property consolidation was seen among bigger companies: Where in the past companies were happy to occupy three or four buildings, they are now choosing to consolidate into a single building. An example is Sasol, which will be relocating its employees from a number of buildings in Rosebank to a single building in Sandton. Looking at the concentration of office development activity, Sandton as a node is, however, becoming concerning. More than half of the office space being developed in South Africa is in Sandton. Smaller tenants may choose to decamp to neighbouring areas to escape the high rentals and worsening traffic congestion.

Industrial tenants should benefit from the weaker rand and the lower oil price, and vacancies have remained stable for the past year or two at around 3%.

Super regional shopping centres continue to see double-digit trading density growth. For the first time in many years, neighbourhood shopping centres have also shown an upward trend. However, there has been some fallout from the Ellerines failure, and Edcon, which has a stretched balance sheet, is also concerning. While there is only a small risk of the company not surviving, Edcon does represent an estimated 9% to 10% of all shopping space.

Some of our preferred holdings include:

Intu, which owns shopping centres in the UK, has benefited from rand weakness, but has battled operational challenges. However, for the first time in many years, the UK is seeing positive rental growth. Intu has also acquired shopping centres in Spain, and any recovery in that market should feed through to its earnings.

Attacq has a large project pipeline and offers significant growth potential in its long-term net asset value (NAV) due to its development of Waterfall Estate in Gauteng. The Mall of Africa, which is at the heart of this new suburb, is due to open next year, and should further invigorate that area. A recent transaction with Atterbury gave Attacq full ownership of Waterfall Estate and more control over the build-out process. This should lead to an accelerating of the development pipeline over the next five to ten years (rather than ten to fifteen years).

Fortress A shares offer a defensive holding (the B shares will be taking the initial loss if overall income growth is negative) as well as offshore diversification, with 40% of its asset base offshore via Nepi and Rockcastle.

Investec Property (the listed fund, not the unit trust) has a solid portfolio of assets with above-sector distributions. It has a well-regarded management team and offshore exposure via Investec Australia Property.

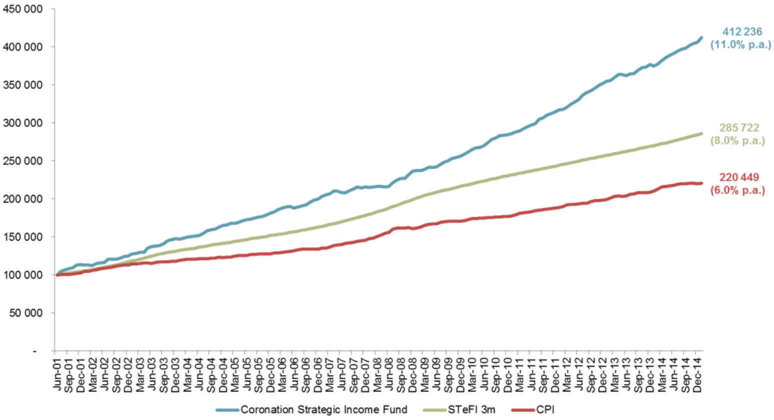
Our international holdings include **Growthpoint Australia**, which is yielding more than 7% and has a defensive lease expiry profile. Growthpoint South Africa is the anchor shareholder, holding two-thirds of the Australian company. Redefine South Africa and Redefine International are the key shareholders in the Australian-listed **Cromwell Properties**, which is also yielding more than 7%. **Japan Residential** is a UK-listed fund that focuses on Japanese residential assets. While yen weakness has negatively impacted its earnings, the fund is yielding 6% with rerating potential.

Looking at the year ahead, the listed property sector should remain well supported. Current bond market conditions are likely to provide a solid underpin. Dividend growth prospects remain above inflation, with expectations of 7% to 9% per annum for the next 18 to 24 months. In addition, thanks to the REIT conversion, potential support can be expected from offshore yield-seeking investors. However, sector valuations are not particularly cheap and may be impacted by unexpected movements in interest rates and bond yields. It is therefore not prudent to expect a repeat of the stellar performance in 2014.

CORONATION STRATEGIC INCOME FUND

The fund aims to provide a higher total return than a traditional money market or pure income fund, with an internal objective to produce at least cash plus 2% per annum without taking inappropriate risks.

Coronation Strategic Income Fund

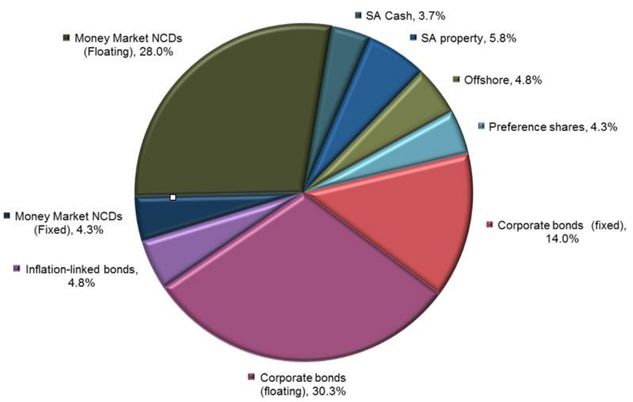


Since inception (2 July 2001) to 31 January 2015

The Coronation Strategic Income Fund has not had a negative return since inception over any rolling 12-month period. The fund invests across the full range of income-generating asset classes including the money market; Negotiable Certificates of Deposit (NCDs); government, parastatal, corporate and inflation-linked bonds; listed property, offshore bonds and preference shares. The fund has a 25% risk budget made up of maximum 10% in listed property and 15% in 'other investments' (preference shares and offshore bonds/cash). As risk assets usually sell-off in unison, we think very carefully about the downside.

The fund's gross yield is currently at 7.9%. We increased the fund's duration in the third quarter of last year, following an adjustment in inflation expectations, and removed some of the corporate bond duration hedges. Fixed rate bank paper was switched into floating rate instruments following a considerable widening in bank funding spreads after the African Bank curatorship. Floating rate bank NCDs are offering better value than fixed rate bonds for terms of more than five years. Offshore exposure was reduced via currency futures to 4.5% (2.5% excluding Australian dollar and Brazilian real exposure) and we increased our exposure to some property investments.

Coronation Strategic Income Fund asset allocation



As at 31 December 2014

We are also selectively adding corporate bonds, and as always tend to focus on higher-quality issuers (for example, Standard Bank, Momentum and Investec). While credit is useful in generating alpha, we recognise that in a best case scenario, investors will receive their capital and coupons on time. While investors may get a couple of percentage points more from corporate than government bonds, 100% of their capital is at risk. This was sadly illustrated by the collapse of African Bank (Abil). (Strategic Income did not have any exposure to its bonds.)

When considering credit investments, we have a robust process that carefully evaluates the potential downside and risk exposures. This process involves combining the skill sets of both our equity and fixed income specialists, who have extensive knowledge of the companies they review. Little reliance is placed on the credit rating agencies (when Abil went into curatorship, its credit rating was on par with that of MTN and Bidvest). However, we acknowledge that our credit process is dependent on auditors playing their role appropriately in information disclosure.

We expect renewed corporate interest in capital markets thanks to the low interest rate environment. In addition, corporate bond redemptions should boost issuance. No reprieve is expected in the issuance of bonds in state-owned enterprises, with both Eskom and Sanral surviving only thanks to government guarantees.

While preference shares had a disappointing 2014 - due in part to the fallout from Abil, potential tax changes and a large liquidation by a domestic fund - we believe some of these instruments are offering value, with the big four banks yielding 8.5% to 9%. The fund also owns Brait preference shares, which are currently yielding 10%. The company recently sold its stake in Pepkor for R26 billion to Steinhoff, and will seek to gross up the yield earned for any further increases in dividends tax going forward.