EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

FEBRUARY 2017

THE BEST STRATEGY FOR VOLATILE TIMES

The surprising events of 2016 proved that the best protection against an uncertain future is investing in a diversified portfolio of undervalued assets. We are valuation-driven investors, focused on understanding the fundamental valuation of an asset over the long term. Buying at the right price protects investors during periods of volatility as a margin of safety is included. If you stick with this approach for the long haul, it should deliver outsized rewards.

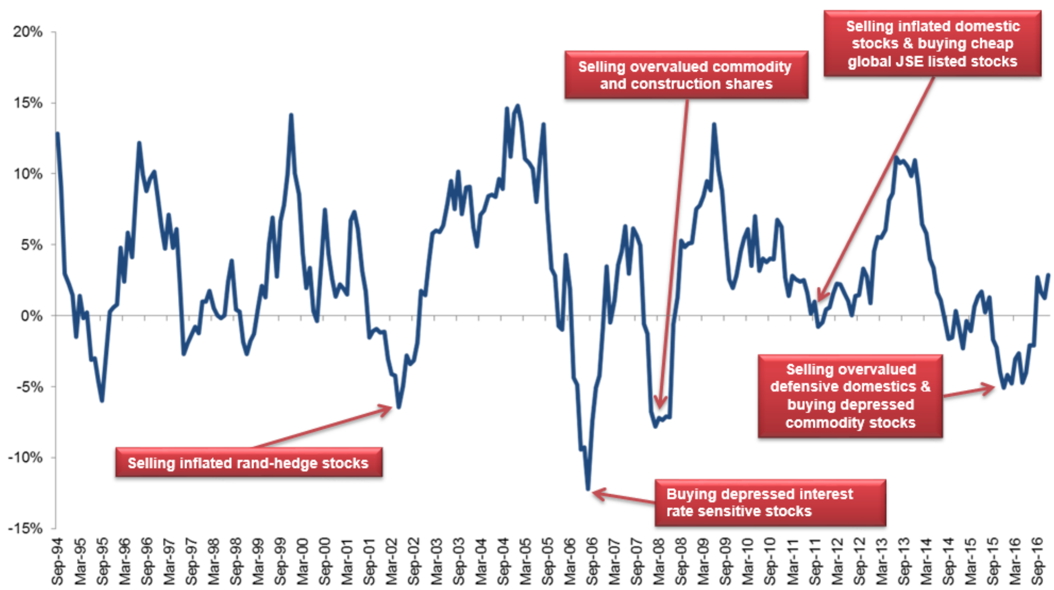
However, while long-term investing delivers compelling results, and intuitively makes sense, living it can be tough. After all, buying low and selling high often results in poor short-term performance. At the time, it may feel like the fund manager has lost it.

We believe short termism destroys wealth, and Coronation remains solely focused on outperformance over the longer term. This sets a more demanding hurdle than aiming for short-term returns. As the time horizon lengthens, the odds move massively against a fund manager. Over three years, 38% of general equity unit trusts beat the market. This falls to 14% of general equity unit trusts over twenty years - but survivorship bias means that in reality, this number is even lower.

Our funds enjoyed a strong winning streak for an abnormally long stretch of seven years (which started to worry us). The winning streak ended in 2014 and 2015, which were tough years for our funds. But those two years of underperformance were long overdue, and came at the end of a long one-way trend. Our performance turned again in 2016. Due in part to the unexpected election of Donald Trump as US president as well as Brexit, the rand, commodities and emerging markets all rallied (and the global bond bubble cracked) when it was least expected. We did not expect any of these major political developments, but our investors reaped the benefits of portfolios that were put together in a disciplined manner, where the fund manager had done a decent job of selling overvalued assets and buying undervalued assets.

Portfolio actions that deliver short-term pain for long-term gain

Coronation Houseview Equity portfolio, one-year rolling alpha



As at 31 December 2016
Benchmark: ALSI, Low-mining, CAPI (prevailing benchmark at that time)

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CORONATION
TRUST IS EARNED™

INVESTING IN A LOWER-RETURN WORLD

AVOID TYPICAL MISTAKES

In times of stress, the human impulse is to take action. When investment returns start to sink, this instinct could drive investors to do something – anything – just for the sake of taking action. This is precisely the wrong reaction in challenging times.

There are many knee-jerk responses to short-term underperformance – all of which will ultimately detract from long-term returns:

Switching to cheaper products

In a low-return environment, clients typically consider cheaper managers or passive products to save on fees. However, this is precisely the time that outperforming the market becomes even more important. In a high-return environment, alpha is nice to have. When the market delivers 15%, it's nice to achieve an outperformance of 2% or 3%. But in a low-return environment, outperformance really starts to matter. Outperformance of 2% to 3% on a base of 9% is a must-have: The difference between 9% and 12%, compounded over years, can transform your retirement. Skill in delivering strong outperformance becomes more valuable (not less) in challenging times. Investing with managers that have a demonstrable track-record of successful asset allocation will become even more important.

Cutting exposure to risk assets

When the investment outlook and market sentiment are poor, stressed investors often lose their tolerance for volatility. However, it is crucial that investors maintain appropriate exposure to growth assets, which are the only investments that will provide the real long-term growth investors require.

Shortening your time horizon

The temptation is to shorten your investment horizon – instead, it should be lengthened. Identify long-term winning managers and asset classes, and back them for the long run. Don't fidget or lose faith at precisely the wrong time.

RETIREMENT INVESTING

In a low-return environment, it is key that your clients exact strict discipline in their draw-downs. The gains from reducing annual drawdowns is non-linear. A small reduction in the drawdown rate can add years of additional retirement income.

It is also important to understand the place of underwritten annuities in the market. In times of low returns, it is tempting to buy an underwritten annuity. But investors should be sure that the product is suitable to their needs. Be very careful of annuities that escalate by a rate below inflation.

Currently, a 65-year-old investor typically gets a 4.7% yield in an underwritten annuity, which escalates at 5% a year. This may feel like a low-risk option, but in fact it is actually a proposition that holds a lot of risk. Over a 30-year time horizon, the power of compounding will not be on your side. In 30 years, something that costs R1 today will cost R4.3 at 5% inflation (compounded), compared to R5.70 at 6% and R10.10 at 8%.

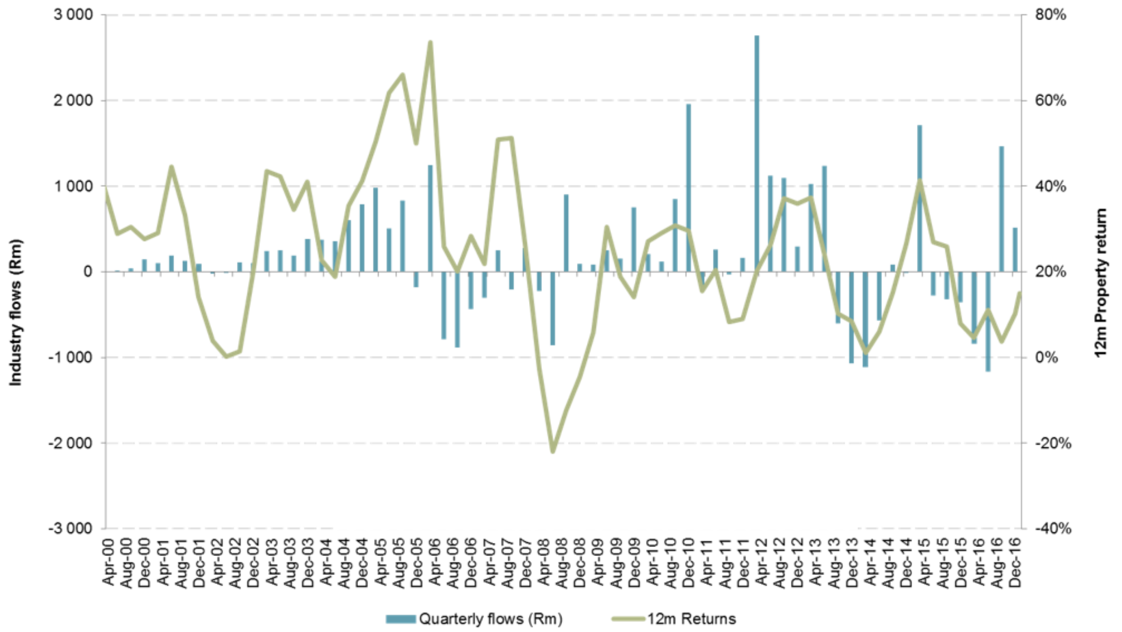
No-one knows the future; South Africa is a volatile and uncertain place, and inflation could just as easily average 8% as 5%. Inflation protection is crucial, and we do not believe investors should consider anything less than an inflationary escalation.

ACTIVE ASSET ALLOCATION

Investing in the right assets is the big call; the most important decision you make in investments. Allocating your investment across the right assets will dwarf the alpha delivered from any single building block. However, client-driven asset allocation can be risky. Often, money is allocated to assets that have been performing well, instead of where future value lies. A case in point (see below) is historical investment in property unit trusts.

Buying high and selling low

Property sector unit trusts versus investment flows



We believe you should leave the allocation of assets to an active manager who deserves your trust, and then measure their performance and hold them accountable over meaningful periods of time.

A multi-asset fund allows the manager to add much more value by being able to use a bigger toolset, beyond the 'vanilla': equities, bonds and cash. These days, there is a large universe of asset classes and geographies, and we use a wide range of these assets. Take for example the allocations in Coronation Balanced Plus, which include investments in Africa outside of SA (3% of the fund), domestic A property shares (3%), German residential property (0.5%), credit bonds (13%), emerging markets (8%), and a small position of less than a percent in commodity exchange traded funds.

Active managers also make asset allocation decisions in real-time as opportunities present themselves. If you have to wait to meet a client, you are inevitably going to miss the opportunity. The same goes for passive funds, which are only adjusted at periodic intervals.

Investing in a multi-asset fund also allows for better risk management. Risk can only be managed if you understand every single security in the portfolio. You can't just put building blocks together and hope for a robust portfolio. When we manage portfolios, we look at total exposure to major risk events – including sharp movements in currencies, inflation and interest rates. We think very carefully about unintended bets and build portfolios that will not blow up when, for example, the rand suffers a dramatic fall. We design stress-tests of alternative scenarios, and add all the different disparate instruments together to find out what the real risk is.

For instance, to understand a portfolio's total rand hedge position, its exposures to offshore equities, inflation-linked bonds, rand hedge equities, rand hedge property and food retailers need to be carefully weighed up. For the impact of interest rate movements, holdings in property, banks and retailers need to be compared. To calculate a portfolio's total inflation hedge, we scrutinise our exposure to inflation-linked bonds, property, food retailers and floating rate bonds.

The aim with our multi-asset funds is to build anti-fragile, robust portfolios that can handle the future playing out differently to expectations. We diversify across sectors, industries, regions and currencies, and don't allow an entire portfolio to hinge on a single view – no matter how much we believe in that view.

INVESTING OUTLOOK FOR 2017

Following the political shocks of 2016, there is an increased risk of adverse political outcomes. For the first time in decades, developed economies are living with meaningful political risk, in particular the risk that populism may undermine globalisation and the free-market orthodoxy which have delivered massive economic dividends across the globe. While the market is prepared for surprises in Europe (ahead of elections in Germany, France, the Netherlands and Italy), we believe the biggest black swan remains China, where big shifts could still take place.

In SA, the ANC's elective conference in December is likely to be a defining event in the country's history. As in many other emerging markets, a political leader can define our country's prospects. There is also still a likelihood of a ratings downgrade in SA. While it has largely been priced into the market, it remains significant if only for its symbolic value. It will attest to the underlying problems in the country, including deficient primary and secondary education, imploding tertiary education and a lacking national productivity ethic. Our people and our companies are becoming increasingly uncompetitive compared to the rest of world. Rising inequality and increasing social tensions are consequences of these problems.

We do not know how current developments, both in SA and abroad, will play out. We spend a lot of time analysing the environment, but we are sceptical about high-conviction forecasts of the future. Instead, our primary focus is on building robust portfolios, securing protection against shocks by investing in assets with cheap valuations, and ensuring appropriate diversification. Some of the current defining views across our portfolios:

Global bonds remain in a bubble

The election of US president Donald Trump was the catalyst for an unexpected slump in global bonds. We don't think the correction is over yet. Global bonds offer return-less risk, with bond markets still close to their lowest levels in many centuries despite worryingly high government debt levels.

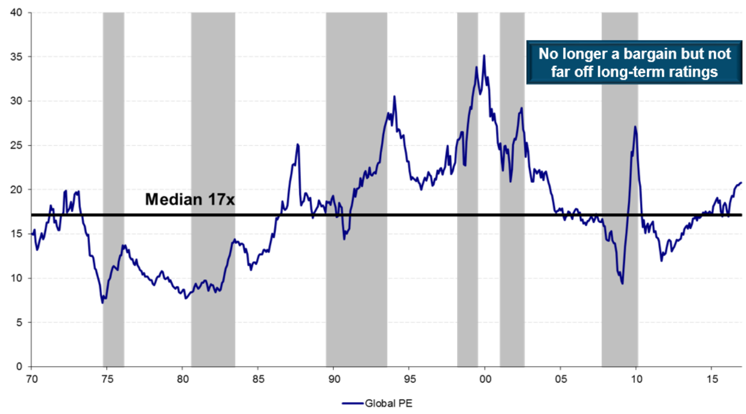
Long-term government bond yields in the G7

Source: Deutsche Bank, Global Financial Data

Healthy portfolio weightings in global equities

These stocks are currently trading marginally above their long-term price earnings ratio averages. Still, we think they look more attractive than the alternatives. We think dollar returns of mid-single digits would be a fair outcome from this base.

Global price/earnings rating



As at 31 December 2016
Source: Citi Research

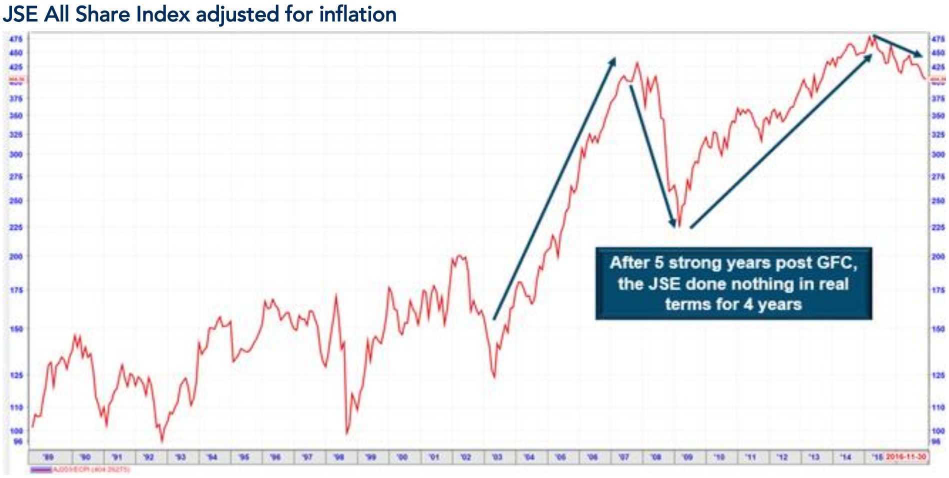
Emerging market equities continue to offer decent value

Much maligned, the emerging market sector gained 12% in 2016 but remains some 30% below its peak. We find many quality companies with great management teams and good prospects trading at attractive levels in emerging markets.

SA equities are looking more attractive

After failing to deliver real growth over the past three to four years, JSE-listed equities are offering value. We bought into domestic equities during the course of last year. In June 2015, the equity exposure of Coronation Balanced was 55%, the lowest in its history. This has since moved up to 66% at the time of writing.

JSE All Share Index adjusted for inflation



Source: INET

Following poor SA equity returns, we have hiked our forecast returns from this asset class for the next ten years:

	Last 10 years (ZAR)	10 year forecast (ZAR)
Local equity	11.4%	8 – 12%
Global equity	9.3%	8 – 12%
Local property	15.8%	9 - 12%
Local bonds	8.0%	8 – 9%
Global bonds	10.2%	4 - 5%
Cash	7.5%	7 – 8%
Inflation	6.2%	6 – 7%

Note that forecast returns have increased in response to poor SA equity returns

As at 31 December 2016

Domestic property trumps bonds.

While we have some exposure to fixed-rate bonds, we remain cautious about the global bond bubble and SA's fiscal prospects. We still have a strong bias toward property over bonds. In the property sector, we generally avoid poor quality stocks cobbled together in the bull market. Instead, we prefer high quality stocks (such as Redefine, Investec and Growthpoint). We believe our portfolio of property stocks can deliver returns of 13% to 15% over five years, comprising initial yields of 8% to 9% and distribution growth of some 5% per year.

UK property stocks are cheap

Brexit has rocked the sector, triggering large losses. UK property holdings have now priced in a lot of the bad news, leaving them on cheap valuations. One of our preferred UK property holdings is Intu, which has a unique portfolio of prime shopping centres. Retail properties are likely to be impacted less by Brexit than office or residential properties. In addition, only about 20% of Intu's portfolio has exposure to London, which will be worst hit by Brexit. Intu is trading on a dividend yield of 4.7%, and at a 32% discount to net asset value.

POLICY AND REGULATORY FRAMEWORK

Local regulators are trying to move South African financial services from a *caveat emptor* (buyer beware) system to *caveat venditor* (seller beware). This obligation requires that all advice and financial products must be motivated by customer interest.

RETIREMENT REFORM

There are two main points on government's agenda for saving sector regulation: social security (government-supplied benefits) and retirement reform (making the existing system more efficient).

Social security: The state wants to add additional government benefits: retirement income, disability and funeral policies. In the best-case scenario, this will augment the current benefits – in the worst, it will displace some private sector activity.

Currently, the thinking is that the existing UIF payroll tax model will be used to fund government-provided benefits. At present, employees contribute 2% of the first ± R150 000 of their salary towards UIF. Under the proposed new model, this will be hiked to 12% of the first R150 000 in exchange for the expanded social payments. Potentially, this will mean that the first R15 000 clients use to buy financial services will go into government-managed products.

We don't believe this will be a likely outcome in the foreseeable future, primarily because it is not affordable without almost insurmountable disruption of the status quo. Also, organised labour will resist the move of private sector defined-contribution retirement plans to contribute to a government fund that is not fully funded.

Retirement reform: The latest draft regulations propose a number of changes to the regulations governing retirement funds:

- Default investment option(s): In a departure from previous draft regulations, the new stance is completely neutral between active and passive options. It does require that the default investment option is simple, transparent, cost-cognisant, fair and defensible, but there aren't additional restrictions to Regulation 28 for the default investment option.
- Preservation option: The new regulations will require that trustees offer a preservation option when members leave the fund, and also that members are 'nudged' to preserve savings at 'accidental' early access points, with the provision of retirement benefit counselling before access to funds will be allowed.
- Retirement income strategy: The proposal is that all funds are required to offer a retirement income option, with members able to opt in or choose their own individual annuity. The income option can be in-fund or out-of-fund, and a living annuity or a guaranteed annuity. Given that it is easier to change the underlying portfolio of a life annuity, that may be the easier route for trustees. This is the only proposal that applies to retirement annuity funds.

The new proposals will further blur the divide between institutional and retail retirement management. Partly through tax harmonisation, the retirement reform favours more standardised individualised funds over employer-specific funds. Trustees will also be required to provide counselling. Together, the new regulations could open up the occupational fund market to more participants, potentially creating opportunities for retail advisers in the corporate sector.

MARKET CONDUCT

Two new regulators will be introduced. The first is a prudential authority as part of the SA Reserve Bank, which will manage systemic risks and institutional sustainability.

The second will replace the Financial Services Board. The proposed new Financial Services Conduct Authority (FSCA) will oversee all types of product suppliers, administrators and advisers. The FSCA will regulate the market according to the proposed Conduct of Financial Institutions (CoFI) act, which can be understood as a "super FAIS act" applicable to all players in the industry. In essence, the intent is for the regulatory approach to become more consistent regardless of the type of investment product, and it will focus on the outcomes of product value, fair disclosure, complaints handling and the balance of accountability across the whole industry. It is expected that the FSCA will be more pro-active and decisive that the current bodies, with significantly enhanced powers (as much as the SA Constitution allows).

RETAIL DISTRIBUTION REVIEW (RDR)

The RDR focuses on a number of areas: the categorisation of advisers, investments, long-term and short-term insurance, sales execution and other intermediary services, as well as promoting financial inclusion of the low-income market.

The first phase of the RDR is nearing completion. It focused on investments via long-term insurance products, and resulted in a proposal to lower exit penalties. Also, it included suggested updates to the FAIS Fit and Proper Requirements, which should come into effect later this year. Included in the updates are new requirements for competence, which require a second round of regulatory exams for all advisers and continuous professional development activities of between 6 to 18 hours a year.

Interestingly, the new regulations require automated advisers (robo-advisers) to comply with all the compliance and record-keeping obligations demanded from financial planners and additional competency requirements for key individuals of affected firms.

The second phase of RDR, which will take place this year, will focus on retail investment products (particularly affecting advisers with white-labelled products and/or revenue from investment management activities in addition to client-agreed advice fees) as well as the categorisation of advisers.

The authorities are currently proposing only two types of advisers. A registered financial agent (RFA) will own their own licence and cannot be a product supplier, although a product supplier may hold shares in the advisory. Having ties with a product supplier will include ownership relations, receiving direct or indirect revenue from a product supplier, outsourcing services to a product supplier or meeting any targets from a product supplier. These relationships will not be illegal, but will attract more intensive supervision and you won't be able to call yourself independent. An RFA will be held fully accountable for the advice given to a client.

A product supplier agent (PSA) can only advise on the products of their supplier, although if the group has a LISP, funds on these platforms can also be recommended. A PSA will operate as part of the product supplier's licence and the latter is therefore fully responsible for the advice given.

Other aspects currently under review as part of the RDR relate to investment pricing. There has been no change in the regulator's views on investment platforms. The RDR supports clean pricing with no rebates, and the platform should continue to collect advice fees on the adviser's behalf, providing regulatory support for the current industry model. Commissions on investment products will continue to be phased out, but it seems likely that this will take pace at a slower pace with more exceptions allowed.

The authorities continue to hold a negative view on white-labelled investment products, and these products may be banned. More detailed regulation of the various types of discretionary investment management is also proposed.

The third phase will require enactment of the CoFI bill, which will put a new licensing regime in place, governing according to activity not product type.

	Theme 1 (Adviser Categorisation)	Theme 2 (Investments)	Theme 5 (Intermediary Services)
Phase 1 (2017)	Tied to/Rep of only one PP/FSP Client data sharing	Primary focus on legacy life industry investment products (reduce exit penalties)	Regulating automated advice Define execution only
Phase 2 (2018-9)	PP responsibility for advice (influence; product knowledge & training) FAIS Competency Framework (using levels of advice definitions) Juristic reps can't provide advice Wholesale advice models	LISPs - phasing out rebates - level playing fields Ban commission on lump sum investments Ban/limit outsourcing of investment management (WL) Require PPs to admin advice fees Further reduce causal event charges	Consider (lightly) regulating execution-only, wholesale & low advice PP responsibility for no/low advice sales Standards for aggregation & comparison services & lead generation/referrals More regulation for low/no advice models
Phase 3 (2019-20+)	New FAIS licensing framework New standards for adviser firms & firm /rep relationships	Ban commission on recurring investments (ex low income market) Further reduce causal event charges	Consider additional regulations for execution-only, wholesale & low advice

TAXES

The world of personal taxes will change more in the coming years than in any period since the early 2000s. A very benign period of taxation has ended as government needs to shore up its fiscal position. The policymaker is also shifting tax benefits away from the wealthy in favour of the middle class through targeted and capped investment incentives. High-income earners will be targeted, which may include the introduction of a marginal tax rate of up to 45%. The tax onslaught on trusts and estate planning can be expected to continue, as well as the possible removal of the interspousal tax-free donations. For advisers, the changes in the tax regime will create opportunities to reconnect with clients and add significant value through their services.

We continue to believe that tax-free investments can play an important role in investor portfolios. Coronation Market Plus was recently added as an investment option that complies with tax-free investment rules. As a long-term, unconstrained, multi-asset fund, it is ideal for this investment vehicle. It offers our best investment view for discretionary investors, and is more flexible that Regulation 28 compliant funds. We will also add further funds in April, including Balanced Defensive, Capital Plus, Balanced Plus and Global Opportunity Equity [ZAR] Feeder.