EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

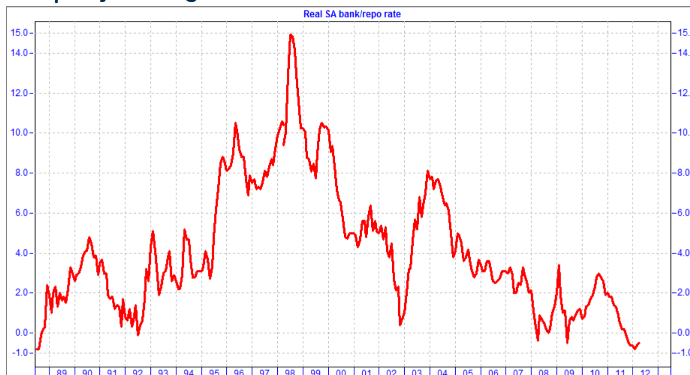
MAY 2012

At the recent round of Conversations with Coronation we discussed our latest fixed interest views and provided some detail on the current portfolio positioning of the Coronation Strategic Income Fund and recently launched Coronation Global Strategic USD Income Fund.

FINANCIAL REPRESSION

South Africa, like many other emerging markets, is importing financial repression; a condition which includes interest rates being kept at an artificially low level by governments or central banks. In South Africa this loose monetary policy resulted in real rates moving into negative territory (see graph below). This means that if you have left your money in cash over the past 12 months, you would have destroyed purchasing power given what has happened with inflation over this period.

Real policy rate negative, lowest since late 1988



Source: I-Net Bridge

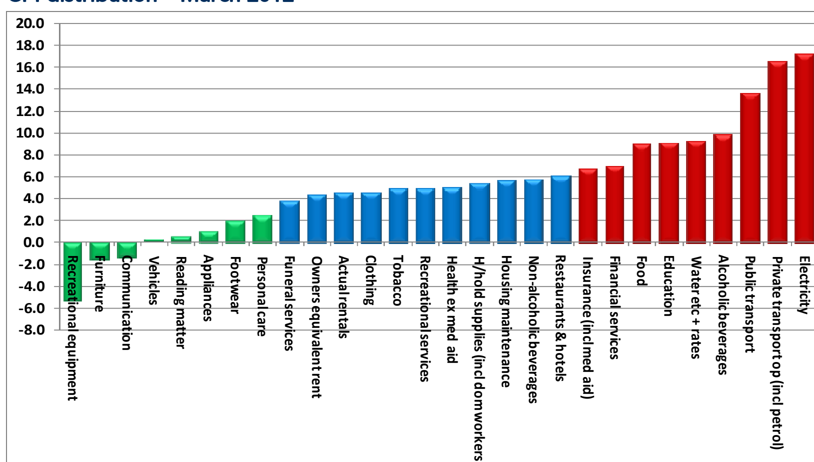
What does financial repression mean for savers? An investor financing US or UK debt in the early 1940s would have lost half their money in real terms over the subsequent four decades as financial repression helped keep yields below inflation and the growth rate of the economy. In SA 1970 - 1990 was largely a period of financial repression during which an investor in cash would have earned -2.1% per annum in real terms, while an investor in bonds would have earned -3.2% per annum in real terms.

In an environment like this one would therefore look to buy inflation-protected assets such as equities, property and inflation-linked bonds. Owning inflation-linked bonds have worked in our favour and we discuss this in more detail below. Furthermore, we believe investors should try to invest with managers who have the flexibility and asset allocating abilities to enhance the yield within their portfolios in order to get them through this period of financial repression.

OUR CURRENT INTEREST RATE OUTLOOK

Key to the interest rate outlook is what happens to inflation. Below we have highlighted the big drivers of inflation, namely electricity, petrol and food. All of these form a big portion of the inflation basket.

CPI distribution – March 2012

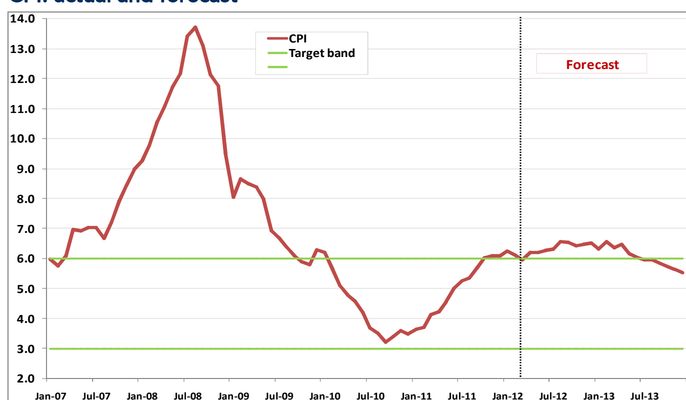


Source: Stats SA

We are however seeing slightly more positive news on the inflation horizon. From a raw food price perspective we are seeing an improvement, while the rate of increase in electricity prices is likely to be lower this year. We are also of the view that the oil price may have peaked. On the negative side we will see some passthrough in terms of processed food prices, there is still an element of rand weakness in the system, and the second-round impact from high petrol prices still needs to come through.

In terms of our outlook, we expect the inflation rate to remain above 6% for the remainder of this year. We also expect it to start moving sideways from the 6.5% level, and to only move back within target range towards the first half of next year.

CPI: actual and forecast



Source: Stats SA and Coronation Fund Managers

This obviously means that we will continue to run negative real rates, a situation which we believe is not sustainable. We believe we are heading towards the first interest rate hike; whether that will happen within the next 6 or 18 months remains to be seen. While the Reserve Bank shares our concerns, they continue to believe that it is not appropriate to raise rates at this point in the cycle, as was illustrated in their most recent Monetary Policy Statement. Their biggest concern continues to be the troubles in Europe and how this is likely to impact our economic growth going forward.

THE CORONATION STRATEGIC INCOME FUND

Strategic Income is a flexible fixed interest portfolio that invests across a number of fixed interest asset classes including cash, government bonds, corporate bonds and inflation-linked bonds. The fund's asset allocation is defensive, keeping exposure to growth assets to a maximum of 25%. These growth assets include listed property (max 10%), preference shares (max 10%) and foreign yielding assets (max 10%), but excludes ordinary shares. The fund aims to protect capital in times of bond market weakness and to provide moderate capital growth. Its benchmark is 110% of the 3-month STeFI Index. The recommended investment term is between 12 and 36 months.

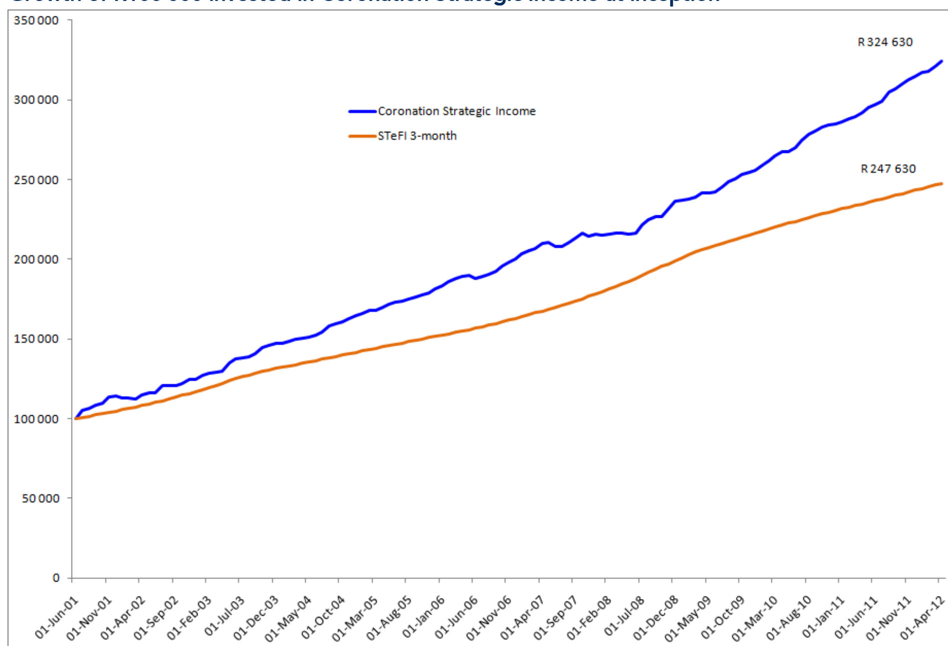
	1 YEAR	2 YEARS P.A.	3 YEARS P.A.	5 YEARS P.A.	10 YEARS P.A.	SINCE INCEPTION*
Strategic Income	11.1%	10.2%	10.4%	9.1%	10.9%	11.5%
Cash	5.5%	5.8%	6.3%	8.1%	8.6%	8.7%
CPI	6.1%	5.2%	5.0%	6.8%	6.1%	6.2%
Median of varied fixed income category	7.9%	7.5%	8.0%	8.3%	9.9%	9.7%

Returns as at 30 April 2012
*July 2001

The fund performed very well over the past 12-month period to end April 2012, delivering cash times two (11.1% versus 5.5%). If one looks at the total return contribution analysis over this period, approximately half of the return came from what we call spread and carry, or otherwise known as the yield, while in excess of 20% of the total return can be attributed to our holdings in inflation-linked bonds. Our foreign holdings also came through very strongly, contributing roughly one sixth of the total return. Our holdings in listed property contributed marginally.

Looking at the fund's performance over the long term, Strategic Income has beaten cash by 2.8% since inception to end April. This annual alpha means that if you invested R100 000 into this fund when it launched in July 2001, your investment would have grown to R324 630 today, roughly 30% more than if you had invested the same amount in cash.

Growth of R100 000 invested in Coronation Strategic Income at inception



Source: Coronation Fund Managers as at 30 April 2012

CURRENT PORTFOLIO POSITIONING

The fund is currently yielding just less than 7.5%, with a duration of roughly one year. It holds in excess of 40% in floating rate notes (a combination of corporate bonds and money market assets) of which the interest rate will move up as the policy rate starts to rise. We have reduced our holdings in inflation-linked bonds from 19% to just under 13% and hold a neutral position in South African property. Our offshore holdings currently total 8%.

Given the expected upcycle in interest rates, we believe that we are well positioned for such an environment through our holdings in inflation-linked bonds and floating rate assets. Our foreign holdings offer diversification in terms of currency as well as assets. We also have the ability to hedge with interest rate swaps. In terms of investor sophistication, we believe the investors in this fund now understand and believe in the benefits of active management within the fixed interest universe over the long term (as illustrated in the long-term performance graph above).

Below we discuss some of the fund positions in more detail.

Inflation-linked bonds

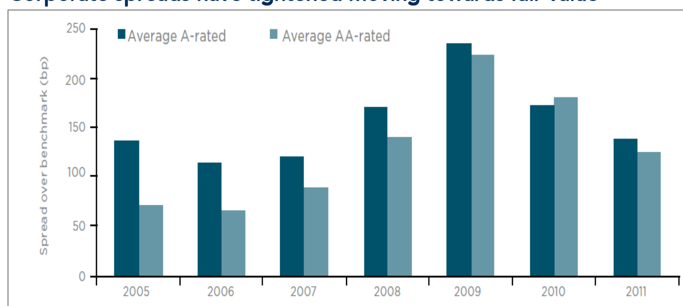
Our holdings in inflation-linked bonds have been a significant contributor to performance, both for Coronation as a house and for our Strategic Income Fund. As mentioned above we however started to reduce our exposure by predominantly selling out of government inflation-linked bonds as we no longer see much value in these bonds at real yields of below 2%. For example, we bought the R197 government inflation-linked bond (maturing in 2023) when it yielded 3% real. The bond is currently yielding 1.87% real. From a breakeven rate, the market is probably fairly pricing inflation at the moment which means that the benefit of holding government inflation-linked bonds no longer outweighs holding fixed-rate government bonds. We are also likely to see an increase in supply of government inflation-linked bonds, with government already having announced three new inflation-linked bond issues this year.

While we are not going bearish on inflation-linked bonds, we have started to lock in some of the performance achieved in our government inflation-linked holdings. We continue to hold on to the corporate inflation-linked bonds in our portfolio as they continue to offer very attractive real yields.

Corporate bonds

Roughly a quarter of the fund is invested in a high quality portfolio of corporate bonds. We accumulated the majority of our holdings in corporate bonds when the average corporate bond spread over government bonds blew out to almost 250 basis points in 2009 following the credit crisis (see graph below). Today, we believe one is still able to find attractive deals, despite the general compression in spreads.

Corporate spreads have tightened moving towards fair value



Source: Collective Insight

Property

From a property perspective, our holding is relatively neutral. The three biggest domestic holdings include Fountainhead, Acucap and Emira (each roughly 0.5% of fund). In addition, we have slowly started to build a position in Hyprop which currently yields 7.3%, the cheapest it has been relative to the sector for the past five years. Its portfolio of properties includes top quality assets, including Canal Walk, Cape Gate, Rosebank Mall, The Glen and Hyde Park. We also hold 0.6% in Capital Shopping Centres (CSC) where, despite a weak UK retail environment, we believe there is upside in terms of earnings. The quality of CSC's portfolio also remains high in our view.

Offshore

The fund may invest up to 10% offshore. We currently have a total of 8% invested in offshore assets. Our US dollar exposure (2.6% of fund) is through the recently launched Coronation Global Strategic USD Income Fund, which we will discuss in more detail below, while just over 1% of our offshore exposure is held in Growthpoint Australia, an asset that is yielding in excess of 12% in Australian dollars. The balance of our offshore holdings is held in hard currency issues by a number of quality corporates and banks.

THE CORONATION GLOBAL STRATEGIC USD INCOME FUND

The Coronation Global Strategic USD Income Fund builds on the exceptional track record of its local sibling, Strategic Income. It is an asset allocation fund utilising the different fixed interest asset classes, aimed at conservative investors looking for an intelligent alternative to US dollar bank deposits. Even though we have an internal target of producing cash +2% in US dollars, the fund's benchmark is 110% of US 3-month Libor. The fund is also suitable for investors seeking to utilise their offshore allowance in a conservative manner.

Coronation Global Strategic USD Income has a flexible mandate with no duration or term restrictions and the objective of achieving capital growth and a competitive annual yield. It also aims to protect capital in a rising rate environment, or to enhance yield as rates decline/move sideways. Its asset allocation is defensive, however it can invest up to 10% in listed property.

While the fund may invest in instruments denominated in any currency, its effective exposure to the US dollar will be at least 75% at all times. We expect the volatility of this fund to be higher than the local Strategic Income fund. The recommended investment term is at least 6 months, but no more than 60 months.

WHY IS THE PORTFOLIO LIKELY TO BE MORE VOLATILE THAN STRATEGIC INCOME?

There are two key reasons why this fund is likely to be more volatile than its local sibling. Firstly, if interest rates were to rise by a small margin and as a result the price of the bonds fell, one would make a small capital loss. In the local market, you still have an income yield of between 6% and 8% to act as a buffer, while in the US market you only have a quarter or half a percent worth of income to buffer your capital loss. All else being equal, the fund will be more sensitive to movements in interest rates and as a result more volatile on that basis. Secondly, given that corporate bonds and other securities tend to be more actively traded in international markets than in the local market, this also adds to the price volatility of these assets and ultimately of the fund.

Some of the volatility could be reduced if you put together a multi-asset portfolio of corporate bonds, inflation-linked bonds and floating rate notes, however it won't be possible to reduce the volatility completely and investors should therefore expect the fund's volatility to be higher than that of Strategic Income.

Our risk management objectives in managing the fund are to avoid peak-to-trough drawdowns of more than 3% and to always produce positive returns over any 12-month period.

CURRENT PORTFOLIO POSITIONING

The fund was launched in January 2012 and is currently yielding about 3.8%, substantially ahead of US cash. Its duration is just under a year, but taking into account that we have hedged out some of the duration associated with our corporate holdings, we further reduced that to about half a

year's worth of duration. The fund can have duration of up to three years, but to go to that level, rates would have to be extremely attractive given the volatility targets we have within the fund.

In terms of our fund holdings we have a good mix of instruments such as floating rate notes and shorter-dated inflation-linked bonds, where we believe there are still a few opportunities. In terms of growth assets, we have 5.9% of the fund invested in property. We also hold short-dated corporate bonds.

In terms of the jurisdictions of our holdings just over half of the portfolio is invested in the US, just over a third in Europe, and the balance in the UK, Australia and Singapore. All of the currency exposure is however hedged back into US dollars at this point in time.

Below we discuss some of the fund positions in more detail.

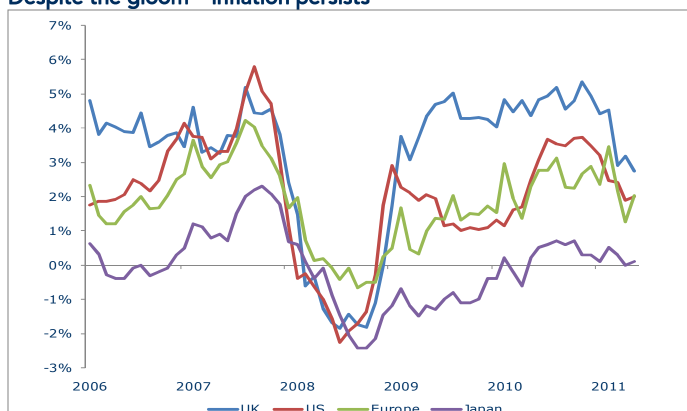
Floating rate notes

We currently have a healthy portion (one third) of the fund invested in floating rate notes. The returns on these instruments will increase as interest rates start to rise and therefore offer protection against spikes in the interbank market. A number of South African names are included in our floating rate note exposure. We believe that many offshore investors are not familiar with South African entities issuing in the international markets. Given that we know these entities very well, we can take advantage of the risk premium associated with these South African names that issue abroad.

Inflation-linked bonds

While longer-dated inflation-linked bonds in the US are already trading in negative territory, we have found some value in very short dated inflation-linked bonds. Despite the austerity measures that are currently in place in much of the developed world, people incorrectly assume that these markets do not experience inflation. Inflation has however been very clear across the major markets over the last few years, mainly due to rising food and fuel prices, which has also been the key drivers of inflation locally.

Despite the gloom – inflation persists



Source: Bloomberg

We believe these factors will start to roll over somewhat this year, but are likely to be replaced with taxes as governments look to raise more money through such measures. One should also note that a large portion of the US inflation index is based on housing. As the housing market bottoms out and start to pick up, this will have an impact on US inflation.

Corporate bonds

Again, while corporate bond yields have also been depressed by the very low government bond yields, one of the areas we can look at is corporate bonds that hedge out the duration (interest rate risk). We continue to find such bonds that offer decent yields. Similar to our floating rate note holdings, we take advantage of the attractive spreads offered by South African companies that issue corporate bonds in international markets.

Property

We currently have a 6% exposure to property within the fund. We have found attractive opportunities in Australia, Europe and the UK. Our decisions are not driven purely by the yield argument, but by ensuring that we pay the right price for the securities we invest in. We prefer buying securities that are trading close to or below their net asset values. We also consider the intrinsic quality of a portfolio and catalysts for change. An example of intrinsic quality is Growthpoint Australia's long leases and high quality tenants, while an example of a catalyst for change is Capital & Counties' redevelopment of Earl's Court and Covent Garden that we believe will boost net asset value over time.

Currency

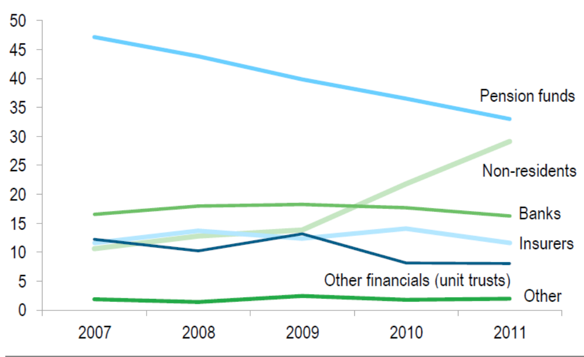
This fund may hold up to 25% in non-dollar currencies. However, we don't believe we would be able to sustainably meet our capital preservation and volatility targets by having 25% in non-dollar currency. Currency volatility tends to dwarf interest rate volatility and this is particularly true when you have very low interest rates as is currently the case. In order to deviate from your base currency in a portfolio like this, you really need to have a high level of conviction.

SOUTH AFRICA'S INCLUSION IN THE CITIGROUP WORLD GOVERNMENT BOND INDEX (WGBI)

It has been announced that South Africa will be included in the Citigroup WGBI in October, subject to our meeting of the Citigroup criteria through May and June. Given the expected weighting of 44 basis points, this is likely to equate to a R50 – R60 billion inflow into the country, an amount that could effectively fund between a third and half of this year's budget deficit. This is a substantial amount and can lead to increased demand for our bonds (as was already illustrated shortly after the announcement of our inclusion) and add some support to the currency.

It is interesting to note the extent to which foreigners have started to show interest in the local bond market. The graph below illustrates the percentage of ownership of South African government bond issuance over the past five years. In 2007 South African pension funds held close to 50% of government debt in issue, while today they own about 35%. Conversely foreigners owned about 10% of government debt five years ago and today they own in excess of 30%. This is likely to increase even more. We believe this is very positive for the country as foreigners are not being forced to buy our bonds. However, these foreigners would also exit the market should they disagree with where local policy is headed.

Foreigners already second-largest holders of SA bonds



Source: Standard Chartered

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