EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

OCTOBER 2012

At the recent round of Conversations with Coronation we shared our views on the current global macroeconomic environment, discussed what we believe to be appropriate strategies for post-retirement income investors, and provided an update on our post-retirement income solutions: Coronation Balanced Defensive and Capital Plus.

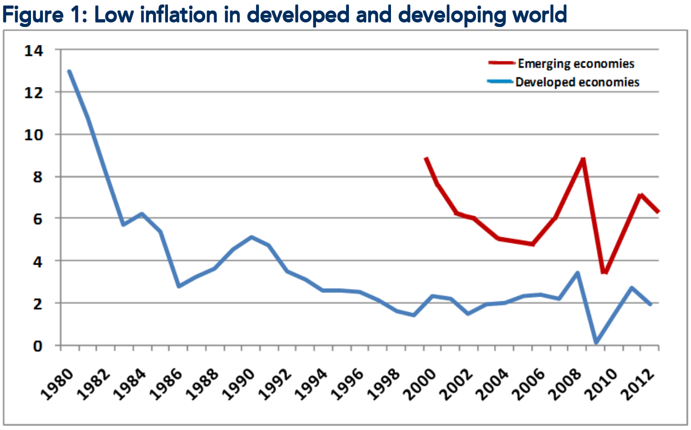
THE GLOBAL MACROECONOMIC ENVIRONMENT

The world is trapped in an environment of low growth, low inflation and very low rates of interest, and this is likely to remain the state of affairs for the next couple of years.

Low growth: Among the developed world countries, the US economy is faring the best. It is however only growing at 2% per annum which, despite 0% interest rate policies and numerous unconventional quantitative easing strategies, is below trend. Europe is in recession and Japan has been ex-growth for the past 20 years. In the developing world, the picture is not looking any brighter. Economic growth in China, for long the saviour of the global economy in general and commodity exporting countries specifically, is slowing down. Despite economic growth of 7% - 8%, which is still a reasonable number by anyone's standards, this is below trend for the country and also dragging down the rest of the developing world.

Low inflation: Combined with low growth, we also find ourselves in a low inflation era. The blue line in the chart below shows inflation for the developed world since 1980. For the last 10 - 15 years inflation has settled at around 2%. The red line represents inflation in the developing world which, despite being 3% - 4% higher than that of the developed world, is also under control.

Figure 1: Low inflation in developed and developing world

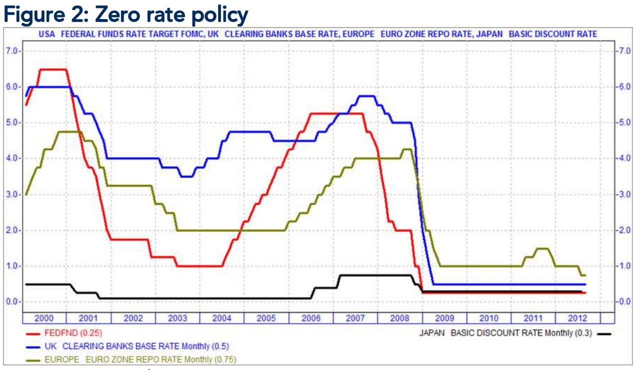


Source: International Monetary Fund

Low rates of interest: In addition to low growth and low inflation, rates of interest are extraordinarily low. Part of the background to this lies in the debt supercycle (a period during which balance sheets expanded significantly) that came to an end around 2007/8. Now that the world finds itself in an economic recession, and people are not incurring any new debt - even at very low rates of interest - governments have to find ways to stimulate the economy. Given that many governments are running colossal fiscal deficits, they have only one weapon to try and stimulate growth: extremely accommodative monetary policies.

The following graph illustrates the official rates of interest in the world's major economies. Japan (black line), the US (red line), the UK (blue line) and Europe (green line) all have interest rates below 1%. This has been the case for the past three years and, in the US, looks set to be the case until mid-2015 and possibly beyond that.

Figure 2: Zero rate policy



Source: I-Net Bridge

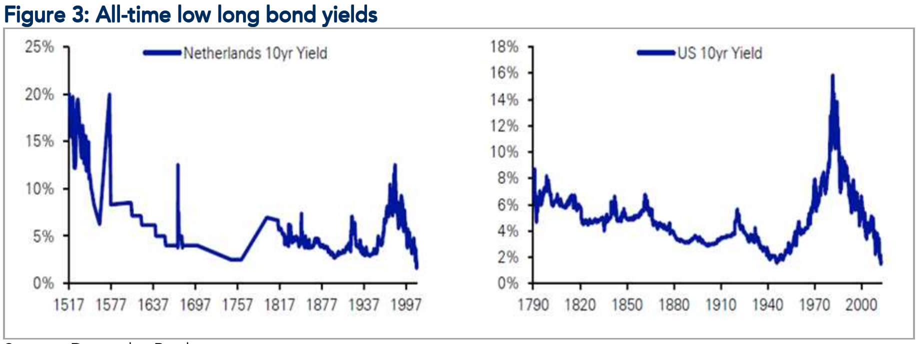
What can we conclude for now?

- The world is caught in a low growth, low inflation and low interest rate trap
- The main investment theme is therefore the search for yield
- Warning: Abnormal policies lead to abnormal asset prices
- Bubbles forming in yield-driven investments

Following the collapse of Lehman Brothers in 2008, we realised the key question to ask is: 'Where is the next bubble likely to take shape?' While many of us initially thought that these extraordinary policies may lead to a bubble in inflation or commodity prices; in a world of virtually 0% interest rates there has been one driving force – the search for yield - and in our opinion a bubble has started to form in higher yielding assets such as government bonds.

Consider the following long-term graphs illustrating Dutch and US 10-year government bond yields. The yields on these respective bonds are at their lowest in recorded history, and have been driven to these low levels by the global search for yield.

Figure 3: All-time low long bond yields



Source: Deutsche Bank

This has also been the case in South Africa. If you look at Figure 4 below, it is clear that yielding assets in SA have benefited from the search for yield. The red line represents our 10-year government bond yield and the blue line represents the listed property index. While interest rates are low by historical standards, they are high in comparison to the rest of the world. For the last few years money has poured into our bond market as foreigners were attracted by yields of between 7% - 8%, which is much better than the yields of between 1% and 2% available in developed markets. This inflow has supported the rand, helped push our bond yields lower and assisted the government's funding of the fiscal deficit. In our opinion, these yields have been pushed too low and therefore no longer offer any value.

Figure 4: The search for yield in SA

Source: I-Net Bridge

When will interest rates start to normalise?

For interest rates to normalise, global economic growth needs to be much stronger than it is currently and/or inflation needs to move significantly higher. However, neither of these occurrences seem to be on the horizon as yet, and we expect to remain trapped in this low growth, low inflation, low interest rate world for some time to come. Thus, the search for yield is likely to continue.

Given our valuation-driven approach to investing, we have already been taking profits on the yielding assets in our portfolios due to our view that the ability to earn a reasonable return on these assets is becoming increasingly difficult. This view means that we hold above average exposure to

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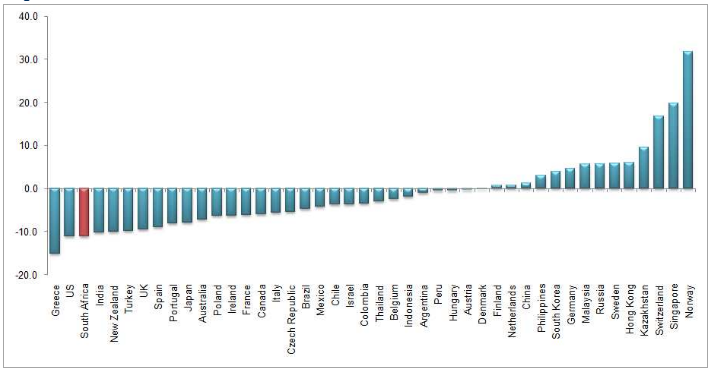
cash and near cash assets in our income-and-growth funds, where we are required to hold a significant component of the portfolio in income assets. While cash interest rates are also low, shorter-dated paper is significantly less exposed to capital losses when yields increase.

SA macro concerns

Two major areas of concern in SA include the current account deficit (the difference between our exports and imports and short-term capital flows) and the fiscal deficit (the amount by which government spending exceeds taxes collected). The current account deficit recently soared to 6.4% of GDP, whereas government consumption spending rose to north of 22% of GDP, up from around 20% over the preceding decade. Given that government is not funding their higher spending through higher taxes, they are running a larger fiscal deficit. Fiscal and current account deficits are both indications of an economy spending more than it is earning. These deficits, when combined in a twin deficit index, compare unfavourably to the rest of the world; only beating Greece and the US (see Figure five below). This makes it more likely that the rand will be negatively impacted in the future. Our domestic multi-asset portfolios therefore have full exposure to offshore assets and high exposure to rand hedge investments to try and mitigate the risk of a weaker currency.

Figure 5: Twin deficit index – all countries



Source: I-Net Bridge, South African Reserve Bank

An audiocast summary of our current macroeconomic views is available for download in the Conversations with Coronation section of our website, www.coronation.com

MAKING RETIREMENT INCOME SUSTAINABLE

The issue of drawing an income from a market-linked investment portfolio (most often called a living annuity in SA) is receiving a great amount of academic attention, particularly in the US where for the last 13 years the return on risk assets was negligible. In SA, these products are also extremely popular, with nearly 90% of the compulsory annuity market in 2011 (R31 billion in size) invested in living annuity products. The problem, however, is that more than half of the living annuity investors below the age of 70 are electing initial income drawdown rates of more than 7.5%. Given our return expectations for the domestic asset classes over the next decade, we believe it is very difficult to justify such a high level of income.

Applying a combination of strategies could however assist investors with inadequate capital upon retirement to prudently sustain their desired income levels. These include spending rules, delaying retirement by a couple of years or planning for a decline in spend. We also believe these strategies provide a great opportunity for financial advisors to add value to their clients' portfolios. Given the current global economic backdrop, the low expected return environment, the incredible popularity of living annuities and policy makers' focus on how the post-retirement income market works, it is incumbent on both financial advisors and fund managers to provide good value and sound solutions to their clients.

You can read more about some of the key risks retirees face and the strategies to manage the trade-offs that many retirees need to make in 'Making retirement income sustainable' published in our October issue of *Corospondent*. You can also download an audiocast summary of this article from the Conversations with Coronation section of our website, www.coronation.com.

OUR INCOME AND GROWTH SOLUTIONS

Coronation offers two funds that meet the needs of income and growth investors – Balanced Defensive and Capital Plus. These funds' risk budgets are designed to provide optimal outcomes by balancing the quest for attractive levels of return over the long term, with minimising the risk of capital loss in the short term.

Coronation Balanced Defensive

The fund has delivered a very attractive return of 10.7% per annum since inception in February 2007 to end September 2012. An investment in the fund would have significantly outperformed cash and nearly all competitor funds in its category over all meaningful periods. A key highlight is that over all rolling 12-month periods since launch, the fund has delivered a positive return in keeping with its investment objective.

The return of the past year to end September at 15.9% is higher than what one should normally expect from a conservative product such as Balanced Defensive. We therefore caution investors that returns of this magnitude are unlikely to be maintained in a world of extremely low yields.

Click here to read the latest quarterly commentary of the Coronation Balanced Defensive Fund.

Coronation Capital Plus

The fund has been in existence for more than 11 years and has outperformed its average competitor and benchmark of CPI+4% since inception in July 2001. Over 1, 3 and 5 years and since launch to end September, the fund has delivered first quartile performance when compared against similar funds. We have often commented that the absolute level of historical performance by this fund is unlikely to continue in the post financial crisis world, and over the past five years this became evident. We remain confident that the fund will be able to continue to deliver returns of at least CPI+4% per annum when measured over rolling three-year periods, while protecting capital over rolling 12-month periods.

Click here to read the latest quarterly commentary of the Coronation Capital Plus Fund.