EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

NOVEMBER 2012

We concluded our series of Conversations with Coronation presentations for 2012 with a review of the key themes that are currently relevant in fund management and financial markets. We also provided some clarity on a number of ongoing regulatory and policy debates that we expect to reach closure in 2013.

PART 1 – KEY FUND MANAGEMENT AND FINANCIAL MARKET THEMES

Has Coronation become too big?

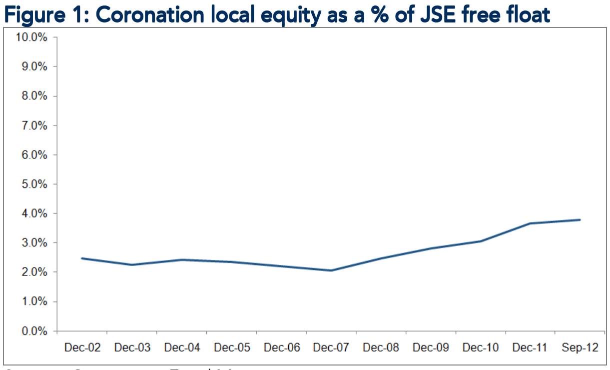
Coronation's asset base has grown significantly over the past three years. Any manager who successfully delivers on clients' return expectations would expect an increase in new assets won. However, the question one needs to ask when selecting a manager to entrust with your assets is: 'Can I trust this manager to put clients before profits?'

As a business that is largely run by investment professionals who live and die by the alpha they produce on behalf of clients, Coronation has proven over the years to put the interests of clients before the next year's profit. Examples include having reduced the fees charged for managing the Coronation Strategic Income and Coronation Capital Plus funds in years when the respective performances of both funds were phenomenal, and without a single client request to reduce the fees. For us, the decision was driven by our expectations of a lower return environment for the domestic yielding assets. By lowering our fees, we share in the *belt tightening* experience that we anticipated the market would force on our clients with income needs. We are following the same proactive approach in dealing with the increase in size of the asset base that we manage.

We agree completely that the bigger your asset base becomes, the more difficult it is to outperform the market. To protect the integrity of our commitment to deliver alpha over the long-term, we will not take on any new institutional clients in our equity, balanced or absolute mandates from the end of 2012. Given that our unit trust funds only represent 25% of our asset base, the retail business will remain open. A further point of perspective on size: a R2 billion fund in 2002 would have grown to R10 billion over the past 10 years purely because the domestic equity market is up five times over the same period. Furthermore, it is much easier to manage R10 billion today than it was to manage R2 billion 10 years ago, given the increase in liquidity on the JSE.

A key metric to watch when you are assessing the size of a manager's asset base is to look at its total equities under management as a percentage of the JSE free float (see Figure 1 below). While Coronation's share of the JSE equity free float has grown over the past 10 years from 3% to 3.5%, we believe that we remain in a position to comfortably beat the JSE. If we underperform, it will be because of decisions made, not the size of our assets under management.

Figure 1: Coronation local equity as a % of JSE free float



Source: Coronation Fund Managers

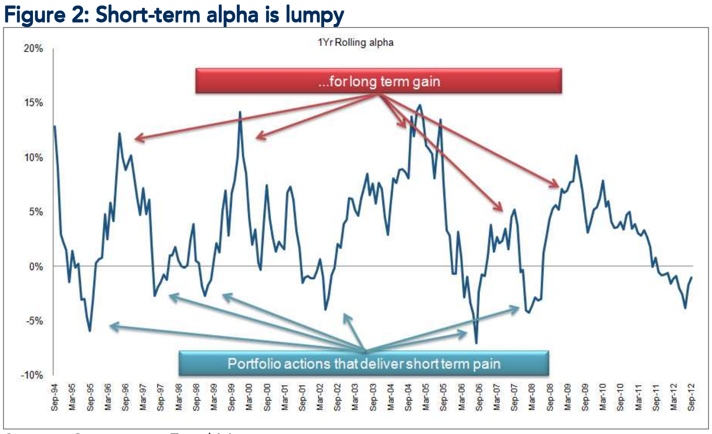
Performance is in the eye of the beholder

The defining aspect of Coronation's investment philosophy is our long time horizon. While we all understand the merits of discipline, courage and the ability to think independently, putting theory into practice is much harder. The average investor cares about three years: last year, this year and next year. Looking beyond those years, however, is the challenge.

For example, if you were a client with a one-year time horizon who invested in one of Coronation's equity funds when we started managing money in 1993, you would have been very unhappy with our performance on a number of occasions, given that we have underperformed the market virtually one in every three years (see Figure 2 below). Ironically, these periods of underperformance are critical to delivering meaningful long-term outperformance, as these were often the points in the cycle where prevailing market sentiment allowed us to buy businesses below their intrinsic value. Any successful track record comes with testing years.

Client Service: 0800 22 11 77 Fax: 021 680 2500
Email: clientservice@coronation.co.za **www.coronation.com**

Figure 2: Short-term alpha is lumpy



Source: Coronation Fund Managers

If the above client's time horizon was adjusted to five years and he or she understood our philosophy of long-term investing, the experience would have been the exact opposite. For the past 20 years (the same period as in Figure 2), we have produced a fairly stable and bankable alpha of 3% - 4% over all rolling 5-year periods. The client with a meaningful time horizon did not endure a single day of underperformance over any rolling 5-year period (see Figure 3 below).

Figure 3: It is over the long-term that we measure results

Source: Coronation Fund Managers

Are investors expecting too much from Coronation Strategic Income?

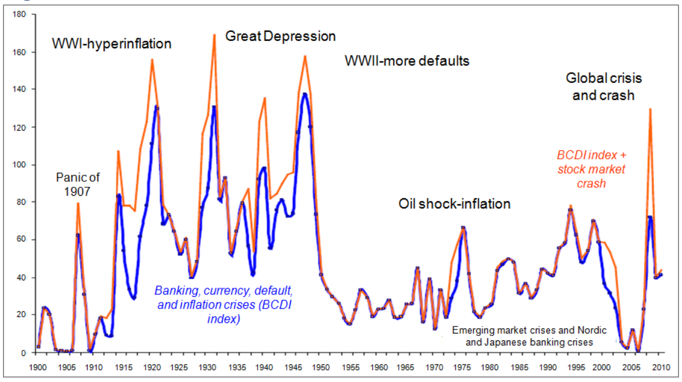
Our flagship fixed interest fund, Coronation Strategic Income, has delivered incredible returns over the past few years and as a result has attracted a large amount of inflows. The fund is currently R17 billion in size, which is more than two and a half times the size of its closest competitor. We are concerned about the level of inflows for two reasons. Firstly, we believe investors are piling into fixed interest assets at the wrong point in the cycle. There is a major bubble in fixed interest markets around the world, and emerging market bonds are even more overvalued than those of developed markets. This is due to significant foreign inflows on the back of the global search for yield. Secondly, Strategic Income has delivered returns that exceeded expectations (especially the double-digit returns over the past 1 and 3 years) and has been attracting assets based on these historic returns.

A fund like Strategic Income is going to deliver much lower returns in future than it has in the past. This is in line with our messaging towards the end of 2009 when we reduced the fund's fees. Strategic Income is a cash plus fund. If you are invested in the fund because you support its manager and our fixed interest team to deliver cash plus 2% over time, which is in line with its mandate and what the fund has delivered over meaningful periods, you are invested for the correct reason. However, if you are invested in the fund because it has delivered double-digit returns in the recent past and expect this trend to continue, we believe your expectations need to be reset for the years ahead and your portfolio needs to be rebalanced.

The low growth, low inflation, low interest rate hangover

We are living through what is comparable to some of the major disruptions and most difficult periods in market history (see Figure 4 below). What has led to the current environment of low growth, low inflation, overindebted goverments and low interest rates is the unprecedented level of stimulus that policymakers have thrown at the problem in an effort to pull the global economy back from the abyss. However, in doing so, our future has in many ways been mortgaged.

Figure 4: The financial crisis in historical context



Source: Reinhart and Rogoff

Is there a cure for the hangover? Austerity did not work (e.g. Greece is in a depression) and while very accommodative monetary policy alleviated some of the symptoms, it did not result in strong growth or employment, and has significantly increased debt. In our opinion, policymakers are only left with two options: financial repression (essentially a tax on the savings industry) and significant structural reform. Governments have deployed financial repression many times over the past century to pull themselves out of trouble. Today, financial repression has been deployed in various forms and across various markets by means of negative real interest rates (which is incredibly tough on retired investors) and through prescribed assets (where banks, insurance companies and/or pension funds are forced to own government bonds). Another avenue through which government can deploy financial repression is by means of inflation (whereby inflation erodes the real value of government debt); while this has not yet been the case, we believe that over time, the risks are skewed to inflation becoming a reality.

The more difficult and painful option for policymakers is the heavy structural reform that is required in many Western countries. Such reform involves shrinking government's size in the economy, lifting retirement ages and cutting unsustainable entitlements.

In summary, we don't believe hard default is an option. We will see some form of soft default through financial repression and interventions that place a tax on the savings industry. This, we believe, is fuelling the next big bubble in global bond markets, which in our opinion leaves the long-term winning asset classes to be global equities and global property stocks. Both asset classes offer inflation-hedge qualities, have very strong balance sheets and adequately price in the risks present in the system today, which is not the case for the world's major bond markets.

Beware capital inflow bonanzas

The content of a brilliant piece of research by Reinhart & Reinhart on capital flow bonanzas will be very familiar to us as South Africans. The research examines the causes, consequences and policy responses to surges in international capital flows into developing countries spanning many decades.

Some of the common circumstances include:

- foreigners turn with interest to look for opportunity in a developing country;
- the exchange rate tends to appreciate, asset prices rally and local commodity prices boom;
- favourable asset price movements improve fiscal indicators and encourage domestic credit expansion;
- the heavy inflow episode can persist, lulling policymakers and investors into treating the bonanza as a permanent phenomenon rather than a temporary shock;
- the episode ends, more often than not, with an abrupt reversal or 'sudden stop'; and
- real GDP growth and asset prices tends to be higher in the run-up to a bonanza and then systematically lower.

A bonanza is not to be confused with a blessing. We think this is increasingly becoming the situation in South Africa and poses significant longer-term risks to the currency market, to inflation and interest rates.

Click **here** to read the full research report.

Implications for asset allocation

A defining characteristic of mankind is that we are not very good at appreciating what we have. It has been a golden decade for domestic assets, in which an investment in local equities would have doubled every five years and a listed property investment every three years. The ten years of

plenty were based on a bonanza of low inflation, fiscal discipline, strong corporate earnings, an infrastructure boom, cheap power and a strong local currency. We no longer live in this environment and have already reaped the benefits of a wonderful decade where the winners on the JSE (e.g. Capitec, Howden and Famous Brands) enjoyed similar returns to once-in-a-lifetime investment opportunities such as Apple Inc.
We don't believe the next decade will look anything like the past 10 years. While we are not advocating overexposure to offshore assets, it is the major asset allocation decision that needs to be implemented correctly in portfolios over the next decade. The average retired individual's current offshore exposure currently sits between 10% and 15%. We believe it should at least be increased to 20% - 30% of their capital.

This is a view that we have been communicating for the past 18 – 24 months. Our argument is not only risk-based. In addition to the benefit of diversifying your portfolio (reducing your risks), we believe offshore assets will deliver a much better return than domestic assets over the next decade and have implemented this view across our domestic multi-asset portfolios by maintaining full offshore exposure.

Within the global asset class environment we prefer global equities. We believe the bad news has been factored in, resulting in attractively priced assets. We are indifferent to emerging and developed market equities. We have also started to find value in global property stocks in selected regions such as Europe, Asia and Australia where many REITs (Real Estate Investment Trusts) are trading on attractive dividend yields of between 5% - 9%.

Within the fixed interest universe, we are avoiding all overvalued domestic and global government bonds. This decision may well have cost us short-term performance, but we are of the opinion that investors, who continue to ride the wave in these assets, will find themselves unfortunately exposed once the fortunes turn for these assets.

Listed property in South Africa remains vulnerable to rising bond yields and we have therefore reduced exposure. There have been a lot of poor quality listings in our property market in the last few years, which is a classic sign of the top of the market. We think that investors who are invested in poor quality stocks when the cycle turns, will be unhappy with the outcome.

We currently own no retailers and virtually no domestically-orientated stocks. While these stocks were very cheap four years ago, today we believe they are expensive. Instead we are heavily exposed to good quality global stocks such as MTN, Naspers, MediClinic, Trencor, British American Tobacco, SABMiller, Capital Shopping Centres, etc. Within resources, we prefer platinum over gold. We also continue to believe that the diversified miners (particularly Anglo American) offer decent value even though the cycle has already peaked.

In summary, our portfolios show a bias to a weakening rand and a normalisation of interest rates. While we cannot predict the timing of these occurrences, we are quite certain that it will happen within the next 5 years.

PART II – A RAPIDLY CHANGING INDUSTRY

2013 is going to be an important year for our industry (fund managers, platforms and financial advisors) in which many of the regulatory and policy debates that have been on the table for a number of years will come to completion. It is a fairly daunting agenda that impacts many aspects of our industry, but we are very intent on fulfilling our mandate in this process to help protect what is defensible. We believe that if we can assist the regulators and the policymakers by providing an informed view of how the industry works in practice, we should be able to help guide their use of a fine scalpel to remove what is not right, and leave what works well unaffected. If we succeed, we should end up with an environment that is more sustainable in the long run for those who conduct good client-focused business.

The three key areas of policy and regulatory intervention that are of interest include **retirement reform**, **reforms inspired by the 'Retail Distribution Review' in the UK and the 'Future of Financial Advice' review in Australia, and the 'Treating Customers Fairly' (TCF) initiative.** Below we discuss the rationale behind each of these interventions and share our views on where we can help guide the intervention to achieve a more optimal outcome.

Retirement reform

The debate around retirement reform increased significantly towards the end of 2012 with the release of a series of technical discussion papers by National Treasury.

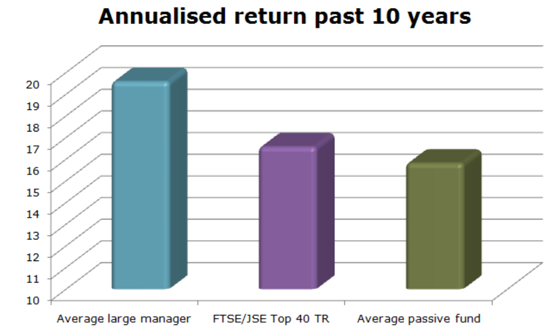
The first issue that National Treasury is trying to address in the retirement universe is to prevent the accidental leakage of retirement savings and to try and force savers to **preserve** their retirement benefits up until the point of retirement. Currently 75% of all South Africans do not preserve their savings when they get the chance to access their capital (for example when changing jobs or when they get divorced). Instead, they fund shorter-term lifestyle needs or pay down debt, which ultimately leave them with insufficient savings at retirement. Should National Treasury be successful in addressing this issue, it will not have a negative impact on our industry. In fact, enforced preservation will lead to a larger savings pool, hence a greater opportunity to manage assets. It will also be very beneficial to the end client whose larger capital base will make a comfortable retirement more likely. National Treasury may however have a slightly less than equal chance of achieving this goal due to the view of organised labour that premature access to one's savings is a hard-earned right and therefore something they would give up with great difficulty.

National Treasury also intend to **comprehensively reform the tax incentives** available for saving on the retirement side, by removing some incentives from the wealthiest tax payers in South Africa and redistributing those incentives to the balance of the working-age population. Their proposal is to cap the tax incentive amount at R250 000 for tax payers younger than 45 and at R300 000 for tax payers older than 45 (both per annum figures). Effectively this will negatively impact the top 1% wealthiest taxpayers in South Africa (roughly 50 000 people). For the remaining balance it will create additional incentives to add to their retirement savings pots. It is also National Treasury's intent to **harmonise the tax breaks** between occupational retirement funds and personal pension funds (retirement annuities), which we regard as a positive.

However, National Treasury is somewhat sceptical about the **value proposition** offered by product providers and financial advisors. Their concerns revolve around active management and whether advice that is given is in the interest of the client or the financial advisor. What they are proposing is for the retirement system to potentially favour passive investment products and be automated, thereby reducing the necessity for fund members to obtain independent advice in the retail market.

We believe we have a very compelling case supporting the **value of active management**. The following chart illustrates the aggregate return of an unbiased portfolio of active managers (the 10 largest active fund managers in South Africa responsible for roughly 80% of all money invested in equity funds) compared to the aggregate return of 8 passive funds that have been in existence for the last 10 years. What is clear is that the average active equity manager has outperformed the average passive manager by nearly 4% per annum. In practice this means that R100 000 invested in the average passive fund ten years ago would have grown to R434 319 compared to the average active portfolio that would have grown the investment to just less than R600 000. We therefore believe there is a very compelling case in favour of active management over meaningful periods. Importantly, these returns are after all management fees and did not consist of selecting the winning asset managers. It is merely an aggregate of all the big funds to which advisors and clients have allocated money.

Figure 5: Annualised return past 10 years



Value of R100,000 invested	
Coro Top 20	R680,346
Active	R597,974
Index	R463,340
Passive	R434,319

Source: Coronation Fund Managers

Furthermore, over a meaningful period, the average passive fund has underperformed the market by R30 000 in the above example. Why? Passive funds are not free; they also charge fees and incur costs such as brokerage and taxes on fees and trading. Over the last decade, the average passive portfolio has underperformed the market by roughly 1% per annum. While those who support passive investing may argue that you should not try to pick the winning active manager/s because it is very difficult to determine who will outperform the market in advance, our response would be that if you are buying a passive fund you are guaranteed to underperform the market by around 1% per annum in the long run.

While we do not have empirical evidence to quantify the **value of financial advice** in South Africa, we can make a compelling argument by referencing two studies that were conducted in Australia and Canada respectively. The Australian study has found that a family who received advice saved AUD1 600 more than a family who did not receive advice. This additional saving, based on conservative assumptions, will amount to AUD90 000 more capital saved at retirement. Similarly, the Canadian study found that an average middle income family who received advice had five times more investable assets than a familiy who did not receive advice.

In South Africa we know that the average advised client starts saving four years earlier than the average unadvised client. We also know that advised clients invested in living annuity products in South Africa have income drawdown rates that are 1.25% - 1.5% lower than the unadvised living annuity investor. Based on our own experience, advised clients are more likely to remain invested for the long term in an appropriately risk-profiled multi-asset fund.

A final issue on the retirement side relates to **the structure of and access to the post-retirement income market**. National Treasury argues that the strong preference for living annuities is influenced by advisors who can earn a higher advice fee on this product than on promoting investments in guaranteed annuities. However, there are very rational reasons for this living annuity product preference in the South African market, which we have communicated to National Treasury.

Firstly, the preference for a drawdown income account linked to a market-linked portfolio is universal and the reason is very simple: most retirees value flexibility and control. A living annuity portfolio allows you to change your mind when circumstances change; that control is not available in a guaranteed annuity where you are essentially locked in for the duration of your retirement.

Secondly, it has been an incredible 20-year period for risk assets in the South African market (equities and listed property), which allowed appropriately structured multi-asset funds, such as Coronation Capital Plus, to achieve a return of inflation plus 8.2% over the past 11 years. Guaranteed annuities, however, are typically priced based on a long-term return assumption of inflation plus 2% - 2.5% on a bond-only portfolio. Because growth assets have performed so well over the last decade, the excess return available from a portfolio containing growth assets exceeded the insurance benefit inherent in a guaranteed annuity for the majority of investors.

Thirdly, if you agree with our view that bonds are very expensive at present and that interest rates are likely to normalise within the next five-year period, you need to ask whether it is wise to make a 20-year purchase decision today based on abnormally low yields. In a few years, once interest rates start normalising again, there might be a much better purchase opportunity for a 'remainder-of-life' income.

We believe the fundamental point is not to argue that living annuities are better than guaranteed annuities – the purchase decision will always depend on the individual circumstances of the client. We also believe that many retirees are best served by a combination between a guaranteed annuity product (which offers certainty) and a living annuity product (which offers the potential of better returns). It however remains our view that the preference for living annuity products is not purely incentive-driven and we believe that if we are successful in communicating this to National Treasury, the required interventions in this section of the market should be less severe than what is currently on the table.

In summary, the interventions that National Treasury is proposing for the post-retirement income market are:

National Treasury's reform proposal	Our response
Automation: Trustees of occupational retirement funds should make default post-retirement solutions available to retirees. If a retiree doesn't act within a prescribed period of time, the retiree gets auto-enrolled into the default option.	Defaults are fine, but you need to allow universal opt out
Require first R1.5 million of compulsory capital to purchase annuity with longevity protection	Tighten boundaries of existing living annuity product, but do not impose rules that will require structural changes in the market
Make living annuities more efficient by improving disclosure, restricting choice and limiting advice fees	Deal with market conduct issues holistically at the regulatory rather than product level

An example of what we could expect in the living annuity market is a reformed living annuity with age and interest rate dependent capped drawdown rates, similar to what is currently being used in the UK. For example, a 65 year old investor in the UK (where long-bond yields are 2%) may take a maximum drawdown from his/her living annuity of 5.3%. If we apply this to South Africa, where long-bond yields are currently 7.5%, an investor of a similar age may take a maximum drawdown rate of 9.1%, which is much lower than the current 17.5% that is currently allowed within a living annuity product.

Figure 5: Annualised return past 10 years

Age	@ 2% long bond yield	@ 7.5% long bond yield
55	4.1%	8.1%
60	4.6%	8.5%
65	5.3%	9.1%
70	6.2%	10.0%
75	7.7%	11.5%
80	10.1%	14.0%
85+	14.0%	18.0%

Source: UK's Government Actuarial Department Capped Drawdown Rate Tables; 2% is the applicable bond yield in the UK in November 2012 and 7.5% is representative of local bond yields.

Secondly, it is likely that living annuities will also be subject to member-level asset allocation limits similar to, or more conservative than, the current Regulation 28 requirements.

RDR and FOFA reforms

Value chain reforms in the UK (Retail Distribution Review) and Australia (Future of Financial Advice) have been/are close to being implemented and it is very likely that we are going to see similar outcomes in South Africa. The reforms are essentially a regulatory intervention in the market to ensure that advisors unambiguously and only represent their clients (i.e. that they are agents of their clients rather than agents of product providers).

What we can expect as a result of these reforms is as follows:

- A ban on commission
  Will mean the end of all-in unit classes, initial commissions, allocation rates above 100% and trail fees
- Charges in the value chain will be unbundled
  Fund management, administration and advice fees to be separately contracted and disclosed
  'All-out' or 'clean' unit classes will become popular
  Advice fee collection through unit redemption still allowed in both Australia and UK
- Yearly or two-yearly advice fee opt-in may be required
- FAIS to be adapted to allow experimentation with low cost advice models

Treating Customers Fairly initiative

The fundamental concept behind National Treasury's 'Treating Customers Fairly' (TCF) initiative is to ensure that the entire financial services industry value chain is accountable for the outcomes achieved by their clients. The fundamental implication is that the advisor and product provider must be able to prove that the client was made aware of any risks associated with the product in the selling process. In other words, TCF will see that as much emphasis is placed on the risks as on the upside of a product. For the advisor this will mean that good records need to be kept.

In closing, it is our view that the intentions of these reform proposals are to ensure a safer financial services environment for all. We remain committed to playing our part in the engagement process with National Treasury to assist in achieving the most optimal outcomes.