# EXECUTIVE SUMMARY
## CONVERSATIONS WITH CORONATION

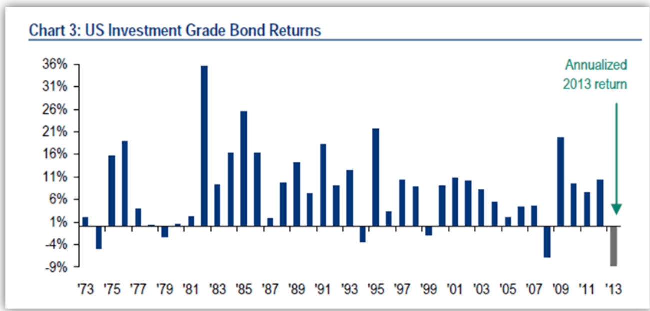
JULY 2013

### GLOBAL ECONOMIC OVERVIEW

The most dramatic event in markets so far this year was the big dislocation - particularly in bond markets - that took place during May and June. This was in response to the US Federal Reserve's (the Fed) announcement that it was considering tapering its quantitative easing (QE) programme in the near future. Instead of the quiet end to QE the Fed had hoped for – where they systematically start to withdraw surplus cash from the system as economic indicators show improvements in the US economy - the announcement sparked a sudden rush to the exit doors.

Why such a sudden rushed exit? One of the unintended consequences of the unprecedented amount of stimulus injected into the US economy over the past 5 - 6 years is the fact that the Fed was not only stimulating its own economy; it was also stimulating every economy in the world. A large amount of the 'stimulus' started flowing into the bond markets of other countries, particularly emerging markets, in search of higher yields. As investors started to realise that the Fed was not going to keep interest rates low forever, they grew fearful of incurring capital losses in their fixed interest portfolios, resulting in a sudden sharp outflow from bond funds. This, as often happens in markets, led to a self-fulfilling prophecy resulting in big losses for bond investors. This move was further exacerbated by hedge funds jumping on top of the trade, and some very significant price moves followed (see Figure 1).

**Figure 1: People buying income don't like capital losses**




### WHAT DOES THIS MEAN FOR SOUTH AFRICA?

South Africa has also been a beneficiary of the 'free money' flowing out of the US. It has allowed our government to borrow quite cheaply over the last few years, even as our budget deficit continued to grow. While interest rates should arguably have risen as we became a worse credit risk (due to our growing budget deficit), they in fact came down, and this meant that the government was able to easily fund an increase in social spending. Similarly, many companies were able to borrow cheaply in the local market, while some of the bigger companies borrowed cheaply offshore as well (by issuing dollar bonds). Remarkably, even as weak as the local currency has been recently, foreigners continue to hold the bulk of the local bonds they have bought previously. The currency therefore remains at risk to further sentiment shocks, especially given the large ongoing current account deficits that need to be financed through foreign inflows.

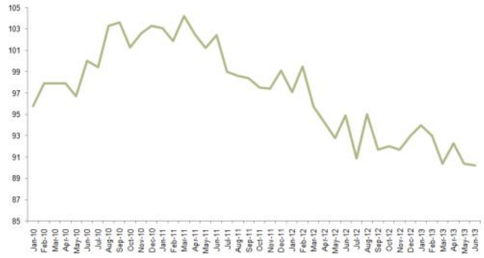
Less quantitative easing in the US means less 'easy money' for South Africa. Ultimately, this means that the government will have less capacity in its budget and as such will have to curb its increases in social spending, and potentially hike taxes. In addition, if the foreign flows into our government bonds dry up, the government will have to turn to the local market for funding. It should be said that interest rates would have to rise before local institutions, such as us, feel comfortable to become significant investors in the local bond market. We do not believe that point has been reached yet.

### SOME MORE CONCERNS CLOUDING THE OUTLOOK FOR THE SOUTH AFRICAN ECONOMY

1) Business confidence is sliding

Confidence in the South African economy continues to decline (see Figure 2). This is bad for growth. For the first time since 1994, South African businesses rank the political climate as the no.1 constraint on business expansion.

Figure 2: South African business confidence index



Source: Bureau for Economic Research

2) Inflation risk

Though we have been surprised by the lack of passthrough in the reported inflation figure, we remain concerned about the impact of a weaker currency, higher prices (fuel, electricity, water, etc.) and above-inflation wage increases going forward. We have also seen the expectation of higher inflation come through in the interest rate environment: during early May forward rates were still implying an interest rate cut versus now implying 2 - 3 interest rate hikes over the next 12 - 18 months. We think this is a fairly unlikely outcome, given the South African Reserve Bank's mandate of targeting growth, but certainly believe that any chance of further monetary stimulus has been swept off the table.

3) Weak domestic demand from lower LSM grouping

Since 2007/08 things have gone incredibly well in the lower end of the market, where the extension of credit has grown by 30% - 40% p.a. This has now started to turn around as a confluence of indicators is putting a lot of pressure on these consumers. This includes large scale retrenchments among unskilled and semi-skilled workers in the mining and construction industries, the tightening of lending by the micro lenders, and the fact that government is limited in terms of the level of social spending increases it can pass through as it simply does not have the budget capacity.

4) The weaker rand helps, but…

While the weaker rand definitely holds benefits for some of the country's manufacturing businesses, it is being eroded by above-inflation wage increases, which means that any competitive pricing advantages gained are likely to be short-lived.

5) Government spending

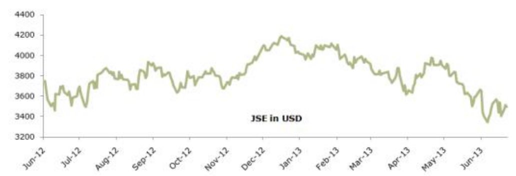
Finally, while government is still spending on big infrastructure projects, a large portion of that spend is on capital equipment, which is being imported. As such, there is very little benefit to the domestic economy.

## YET THE JSE HAD ANOTHER FANTASTIC YEAR

Despite all the bad news, it has been another fantastic year for the JSE, with a return of 21% for the 12 months to end June 2013. Over the 10 years to end June 2013, the annualised return therefore remains spectacular at 20% per annum. We however believe this period to be abnormal, and don't expect a repeat of the last decade's returns over the next ten years.

The US dollar return of the JSE tells a very different story to the rand return. In 2012, the JSE was one of the worst performing markets in US dollar terms. With many of the JSE-listed companies being global businesses, a large part of the rand return we saw last year was simply translation of the weaker currency, and not an indication of the strength of the local economy.

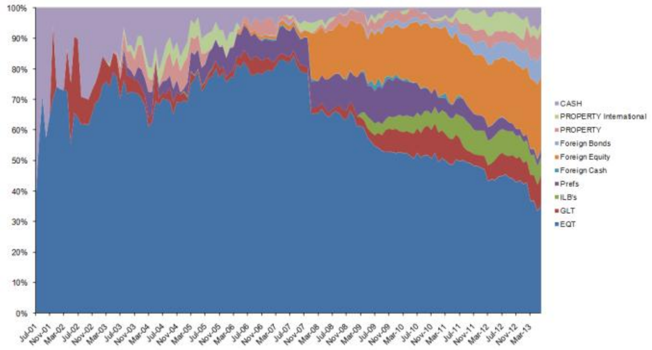
Figure 3: The JSE in rands and in US dollars

### HOW ARE OUR MULTI-ASSET FUNDS POSITIONED GIVEN THIS SCENARIO?

We continue to favour global equities, not as a reflection of how we view the currency, but because it is where we believe the best value are to be found. Global bonds, in our opinion, do not yet offer value, but we continue to find opportunities in selected global property stocks where the pricing is attractive. It is our view that domestic equities are fully priced, as illustrated in the historically low weighting to this asset class in the multi-asset Coronation Market Plus Fund (see chart below). Within the domestic equity environment, we continue to favour quality businesses that are growing outside of South Africa (discussed in more detail below).

**Figure 4: Coronation Market Plus Fund asset allocation as at 30 June 2013**




### HOW ARE OUR DOMESTIC EQUITY FUNDS POSITIONED?

We have not made any significant changes to the top 10 holdings of the Coronation Top 20 Fund over the past year. Despite the substantial rerating in the high quality, globally diversified shares that happen to be listed on the JSE, we continue to find them attractive relative to domestic shares. Domestic retailers have experienced a rather meaningful correction over the last few months. While these are great business with excellent management teams, we have found them to be expensive and as such did not have exposure. Even after the derating, the sector still looks fully valued to us (given the combination of high ratings and still quite optimistic earnings expectations) and we are not increasing exposure in any meaningful manner as yet. We are however increasing our holdings in commodity shares, which have come under pressure, specifically in Anglo American.

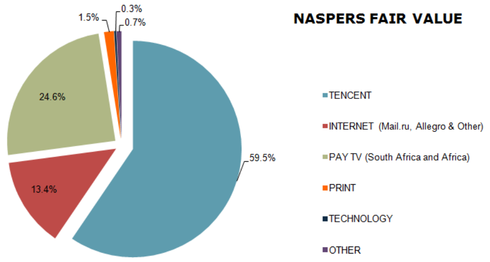
Concerns related to the slowdown in unsecured lending have put the share prices of the large domestic banks under pressure. We have used the weakness to increase our holdings in Standard Bank and Nedbank. While the banks have participated in unsecured lending, their respective personal loan books represent only around 3% of their total loan books. This makes the contribution of unsecured lending to their overall earnings base and loan books quite small. Further notable points regarding both Standard Bank and Nedbank are that both are very well provided, have sufficient capital available and trade on reasonable valuations (roughly 9.5 times forward PE and 5% dividend yields), so we find them to be quite attractive.

#### Why we like Naspers

Naspers has been a core holding of the Coronation Top 20 Fund for quite some time and the fund has benefited from the share's performance. Naspers consists of two businesses: the pay-TV business in South Africa and the rest of Africa, and their internet business in emerging markets like Russia, Poland and China. The pay-TV business is the dominant operator in South Africa and is represented in 48 countries in the rest of Africa. The business has remarkable pricing power. They have increased loyalty among existing customers through the introduction of their HD PVR package and managed to grow their market through more affordable packages such as Compact. We continue to like the pay-TV business as it is a high quality, defensive business that we believe will continue to deliver good earnings growth and the threat from competitors is low. The pay-TV business also generates a large amount of cash, which over the last few years has been used to grow Naspers' internet business, either organically or through acquisition in emerging markets. The internet business has reached a certain scale and they have further enhanced their internet strategy by moving into e-commerce. This move requires time and investment, but we fully support the management team to execute successfully. As the e-commerce business gains traction, it will have many of the pay-TV business characteristics, namely predictable revenue streams and good cash generation.

Our valuation of Naspers is still largely made up of Tencent, which is the largest online gaming company in China. The next pillar of growth for Tencent will be e-commerce, and we try to include some valuation from e-commerce into our fair value for Naspers. The other big components of fair value are the pay-TV business and the other internet businesses in emerging markets.

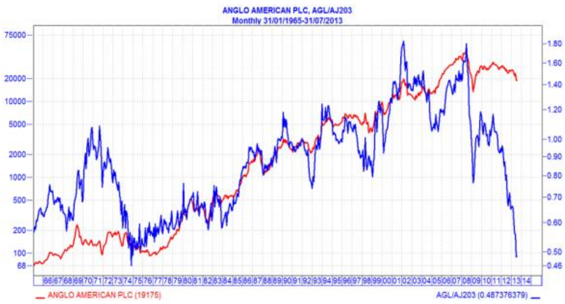
Overall Naspers remains attractive despite the share's exceptional past performance, and we continue to have a core holding in it.




## The case for Anglo American

The share price of Anglo American has been very weak due to a number of factors. These include the impact of slower growth in China on commodities in general, its exposure to South Africa's country-specific mining risks, and a number of missteps by management - particularly poor capital allocation decisions. As an example, Anglo American has spent over $8 billion on investments over the last five years, none of which have yet returned profits to shareholders. Their new CEO, Mark Cutifani, takes the reins at a very tough time for the business, but we believe that given the extent of mismanagement he has a number of options available to turn the business around.

Our investment view is however not based on a short-term catalyst for any of these options - rather it is based on our through-the-cycle valuation, which is the crux of our investment process. The following chart illustrates the scale of Anglo American's underperformance relative to the market (in blue) since 2008. It is almost the cheapest it has been in nearly 50 years relative to the market, and cheaper than it was in the midst of the global financial crisis when all commodity shares were under pressure.




When so much negative sentiment is priced into a share, it is clear to us that the fundamentals are being ignored. A large part of our valuation is based on earnings returning to more normal levels. Our assessment of normal earnings for Anglo American is $2.68 versus the $1.50 the company reported last year. To arrive at this number, we look at each division separately. We normalise Kumba Iron Ore, one of its listed subsidiaries, at much lower earnings than what they currently produce. This is not because we think it is a poor quality asset that will deteriorate over time. Our view of normalised iron ore commodity prices is simply much lower than the current spot iron ore price, which is a big driver of Kumba's earnings. If we normalise Kumba's earnings at the lower iron ore prices it has a negative impact on earnings. However, all other major divisions in Anglos have recently fared much worse than what we would define as normal:

- DeBeers is a unique asset with a dominant position in the diamond market, and we believe that it will recover from recent setbacks.
- Anglo American Platinum, Anglo American's other listed subsidiary, reported a full year's loss in its prior financial year. We think it will return to profitability, especially once the restructuring and review process is complete. We believe this process is necessary and healthy for both the industry and the company, and we think that Anglo American Platinum will emerge as a smaller, lower cost and ultimately profitable operation.
- We also normalise Anglo American's copper and coal assets at higher earnings levels, as we believe these divisions will benefit from increased production.
- Iron ore project Minas Rio, which currently carries a negative value, will eventually contribute to earnings as well, even at lower iron ore prices.
- We also believe there is some fat to be cut from head office and operational costs. Last year, Anglo American spent $1 billion on these two line items, and we think that in a tougher environment more control will be exercised in this area.

In conclusion, we believe that Anglo American looks cheap on a number of metrics - whether it is relative to the market, on a price to book basis, or based on our assessment of normal earnings. The share price offers a large margin of safety, and we are quite comfortable with holding a reasonably large (although not portfolio defining) position.

## APPENDIX I: A FEW GENERAL COMMENTS ON MINING IN SOUTH AFRICA

The gold price declined by 25% in the second quarter of 2013 and local gold shares had an even more torrid time, losing nearly half their value in the first six months of the year. We don't think there would be any argument with the fact that the gold mining industry in South Africa is in terminal decline. It has nothing to do with the cost of labour, productivity or the cost of electricity, it simply comes down to the fact that we've been mining gold in South Africa for 110 years, and we are starting to run out.

But the mining sector forms a large part of the South African economy and feeds through to many other areas of the economy. Hence, the bigger issue to consider is the future of those mining industries that still have a long life ahead, such as the platinum, coal and iron ore industries. We discuss the challenges facing the South African mining industry and how we evaluate local mines as investment opportunities in more detail in the latest issue of *Corospondent*.

To summarise the current issues in the mining sector:

1) Investors have been so disappointed by the poor returns that all the CEOs of the big mining houses, except one, have been replaced, and all have been given the same mandate: stop investing, sell non-core assets and start giving cash back to your shareholders.
2) The labour environment has been very volatile. We have seen the emergence of new aggressive unions that are capitalising on the disenchantment of younger workers with the incumbent unions, which are seen to be too involved in politics and too close to company management. These new unions have been very militant, and following Marikana the perception has unfortunately been created that violent protests are more likely to achieve better outcomes for the workforce. This has resulted in far more aggressive labour relations since and unacceptable levels of violence in the workplace. A mitigating factor, as we go into the current round of wage negotiations, is that most minors are in such dire straits, they simply cannot give in to the excessive wage demands being made.
3) In an ideal world, government should be the impartial party only focused on maximizing the benefits available from sensible and sustainable use of the country's natural resources. They should not favour one union over another, or labour over capital. They should be the independent arbiter of allocating resource rights to those that will most efficiently and responsibly invest and mine in a specific region or commodity. Unfortunately, government has not played a constructive role to date. However, we do welcome their recent focus on the mining industry and the assigning of deputy president Kgalema Motlanthe to head up a coordination body to deal with the significant challenges facing this industry. Sadly, this may be too late to save many jobs in an industry that is now haemorrhaging employees.

We believe the long-term sustainability of the mining sector in South Africa will be achieved with less employees and more mechanisation. More mechanisation, however, means that the industry will offer fewer higher skilled jobs, instead of many lower skilled jobs. This is the only way forward if the industry is to survive, be profitable, and ultimately attract investors.

## APPENDIX II: OUR INVESTMENT PHILOSOPHY

Coronation is a long-term, valuation-driven investment house, with an investment philosophy that is deeply ingrained in our culture. Our aim is to identify mispriced assets trading at discounts to their long-term business value (fair value). We focus on through-the-cycle, normalised earnings and/or cash flow.