EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

DOMESTIC FIXED INTEREST MARKETS

A year ago we cautioned that fixed interest markets appeared to be fully priced, necessitating a lowering of future return expectations. At that point, our flagship fixed interest fund, Coronation Strategic Income, had returned a very strong 11.1% for the prior 12-month period and we expected an element of market normalisation. But as can be seen from the table below, fixed interest assets continued to perform very strongly, and Strategic Income delivered an exceptional 12% for the 12 months to end April.

Fixed interest asset class returns

	1-YEAR
Cash	5.2%
CPI	6.0%
All Bond Index (1-3)	7.3%
All Bond Index	16.9%
GILBI	19.3%
Listed property	43.6%

Note: 1-year returns to end April 2013

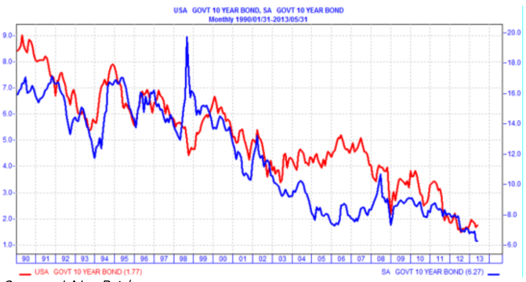
We certainly believe that the available future return in fixed interest markets has now been significantly reduced, and the level of risk associated with achieving cash-plus returns have become much higher. In the final week of May and early June, we already saw the impact of the weakening currency on fixed interest markets and the listed property sector – a scenario that we had anticipated a year ago but is only now starting to play out.

WHY DID THE RALLY IN FIXED INTEREST ASSETS CONTINUE OVER THE PAST YEAR?

As a result of the ultra-easy monetary policy environment, developed market central banks have flooded the markets with liquidity, a lot of which found its way to the higher yielding emerging markets, including South Africa. It is this influx of liquidity that created a very strong bull market in fixed interest assets – a trend that we continued to see during the course of the year.

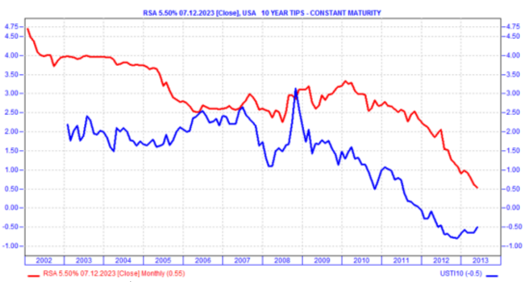
To illustrate the extent of the rally in nominal and inflation-linked bonds, in Figure 1 we have plotted the US 10-year treasury yield against the SA government 10-year bond yield and the real yield of the US 10-year inflation-linked bond versus the SA government 10-year inflation-linked bond in Figure 2. When yields come down, the price of a bond goes up and this is how owners earn capital gains on a bond.

Figure 1: 10-year government bond yields in the US and SA



Source: I-Net Bridge

Figure 2: Inflation-linked yields have followed suit



Source: I-Net Bridge

South African inflation-linked bond yields have rallied all the way to 0.5%, while in the US they are currently trading in negative territory. For investors seeking inflation protection in US inflation-linked bonds, this means that they will pay away -0.5% p.a. in real terms over the next 10 years.

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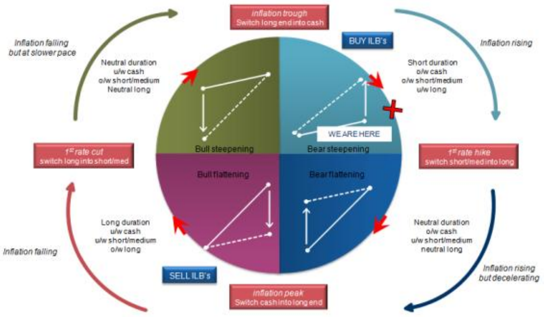
While we believe it is possible for real yields in South Africa to continue to rally to 0%, we don't believe it is likely that we will see much more capital gain from this area of the market.

WHERE ARE WE IN THE DOMESTIC FIXED INTEREST INVESTMENT CYCLE?

We believe that we are still in the upper right quadrant of the fixed interest investment cycle (Figure 3 below), where we see inflation rising, but do not yet see the first rate hike on the near-term horizon. However, if one looks at the bond market's response to the weakening rand in the final week of May, the market has now moved from pricing in a potential rate cut to pricing in a potential rate hike. In the current scenario, we therefore continue to hold some inflation-linked bonds and are running shorter duration positions in the Coronation Strategic Income Fund.

Figure 3: Our fixed interest investment cycle



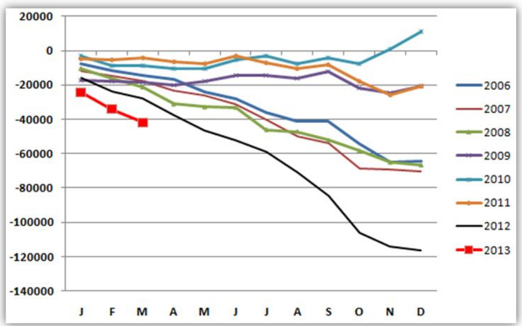
Source: Coronation Fund Managers

WHAT ARE THE KEY RISKS IN FIXED INTEREST MARKETS?

1) *The current account deficit*

A key factor behind the recent currency weakness is the large deficit on the current account, which in essence just means that as a country we currently pay much more for imports than we earn on exports. Figure 4 below shows the annual deficit (or surplus) for each of the last eight years, with each line representing the cumulative trade account balance for the respective calendar year. From 2006 to 2008, our trade account deficit averaged just more than R60 billion per year. As a result of the global financial crisis towards the end of 2008, we moved to a more balanced trade environment as our imports imploded, resulting in much smaller deficits in 2009 and 2011 and even a small surplus in 2010. This benign trade experience enabled our currency to remain reasonably strong during this period. However, this currency strength resulted in more aggressive importing, which started to push the trade account to uncharted deficit levels in 2012. Initially, the rand did not respond to the widening trade deficit by weakening because the shortfall on the current account was more than made up for by very large foreign capital inflows as described in more detail elsewhere. Then in August/September 2012, labour unrest broke out in the mining sector, causing exports to implode, and because imports were still coming through at previous levels and foreign capital inflows paused, the currency started to depreciate. Under normal circumstances you would expect that as a country's currency depreciates, exports should rise as the value of the goods it produces becomes more attractive to foreigners. In South Africa's recent experience the opposite happened however, as mines continued to be affected by labour unrest while attempting to close operations and retrench staff. As a result, we ended 2012 with the largest trade deficit on record of R120 billion, and are already close to R60 billion as of April this year.

Figure 4: Rand vulnerable to large trade/current account deficits



Source: South African Revenue Service

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Stemming some of the currency weakness has been the R90 billion in foreign inflows to our domestic bond market in 2012 and a further R20 billion year-to-date. However, a key downside related to large foreign ownership of our bond market is the bond coupons that need to be paid to the foreign holders of our bonds that essentially flow out of the country via the services account, putting more pressure on the current account.

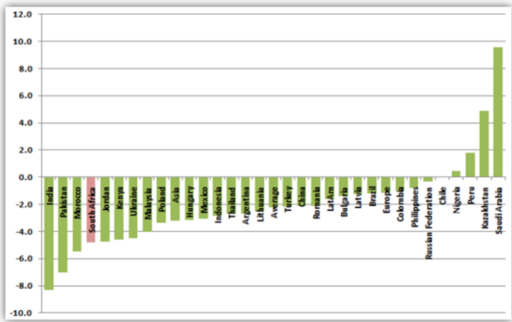
2) *The fiscal deficit*

The fiscal deficit or surplus is very simply the difference between what government receives (in the form of taxes) and what it spends (e.g. in the form of public sector wages). While former finance minister, Trevor Manuel, managed to run a surplus in the 2007/8 period, circumstances deteriorated as a result of the global financial crisis resulting in a defecit of about 6.5% of GDP in the next year. In 2012, five years after the crisis, the fiscal deficit still totalled 5% of GDP, which is indicative of the much tighter economic environment we find ourselves in.

One of the key reasons our fiscal deficit seems to be deteriorating is the level of public service wages, which currently make up 36% of government's total spend. Furthermore, the fact that government continues to miss its own budgets in terms of public sector wage increases is probably the single biggest reason why South Africa was downgraded by the ratings agencies towards the end of last year.

The following chart puts things into perspective in terms of South Africa's ranking amongst its emerging market peers. A number of the countries are using foreign inflows to get their house in order and improve their fiscal deficits, but South Africa has not attempted to do this, which is a big concern should these inflows start to dry up.

Figure 4: Budget balance versus other emerging markets (2013 forecast)



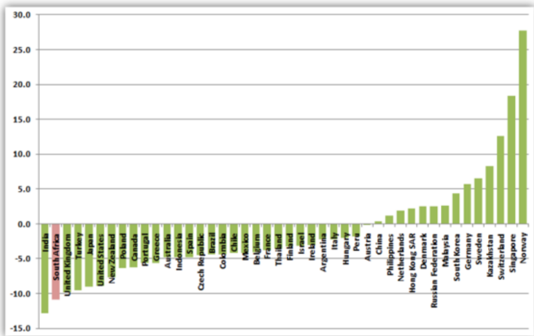
Source: IMF

If we were to translate this deficit into the amount government would need to borrow to finance this shortfall in revenue, the figure comes to R145 billion for 2013. What is concerning is that the South African institutional market is probably not big enough to absorb such a level of debt, and certainly not at yields of 6%.

In terms of government bond ownership, foreigners are currently the biggest holders of South African debt at 36% versus pension fund ownership of less than 30% (in 2008 domestic pension funds owned 44% versus foreigners at approximately 13%). Given the extent of the deficits, we would need foreigners to continue buying our bonds but, again, the more they buy, the more coupon payments will be leaving the country via our services account.

If we then plot our two deficits on a single chart, we find that South Africa has a 'twin deficit' of 11%, which does not compare favourably against the key emerging and developed markets. This is one of the key reasons that is driving the currency lower.

Figure 4: Twin deficits – South Africa even worse that the worst developed markets



Source: UBS, IMF

THE CORONATION STRATEGIC INCOME FUND

We view Coronation Strategic Income as a balanced fixed interest fund that can invest across the full spectrum of income generating assets, whether it is government or parastatal bonds, corporate bonds or inflation-linked bonds. The fund may also invest up to 10% of its portfolio in listed property, a maximum of 10% in offshore assets and up to 10% in preference shares. The fund's mandate is flexible with no term or duration restrictions, and its benchmark is cash.

For the second consecutive year, the fund has exceeded our expectations and outperformed cash by more than 5%. Note that cash has delivered a negative real return as inflation averaged about 6% during 2012 versus 5% for cash. We would like to caution investors again not to expect this level of return relative to cash going forward. Given the fund's risk budget, a much more normal return would be cash plus 2%.

To reflect our current views in a manner appropriate for conservative investors with an immediate income objective, we therefore:

- **prefer to run a shorter duration** in the fund given our expectations for inflation to remain above the 3% to 6% target for the remainder of 2013, and concerns regarding the supply of bonds should foreigners stop buying;
- **prefer hedged exposure to the long-dated area** where we do have exposure in the fixed coupon bond market from a valuation and stage-of-cycle perspective;
- continue to **see value in selected high quality corporate credit** in this low rate environment, but good value opportunities are becoming fewer;
- continue to **like the corporate inflation-linked bonds** we already hold and the medium-dated area of the government inflation-linked bond curve (i.e. inflation protection without significant duration risk);
- remain **neutral on listed property as a whole**, especially the large caps, but find value in certain smaller counters and rand hedges; and
- **hold very little cash** as short rates are likely to remain low and negative real yielding.

THE CORONATION GLOBAL STRATEGIC USD INCOME FUND

Launched at the start of 2012, the Coronation Global Strategic USD Income Fund is very similar to its domestic sibling, Strategic Income. It is a multi-asset fund with a fixed interest bias that can invest in cash, government bonds, inflation-linked bonds and up to 10% in listed property. While it is a US dollar-based fund, it can invest up to 25% in other currencies, but in normal conditions we hedge all the currency exposure back into dollars to help reduce volatility within the fund. We also try to preserve capital over a 12-month period and maintain a maximum drawdown target of 3% over any 6-month period - another reason why we limit our currency exposure.

The fund's benchmark is 110% of US dollar cash. However, given the very low return on US dollar cash at the moment of 30 basis points, we aim to produce USD Libor plus 2%, which is consistent with the cash plus 2% target that the Coronation Strategic Income has managed to achieve in the local market since its inception almost 12 years ago.

Global Strategic USD Income is not a cash fund. Rather, we believe it is an ideal vehicle for investors who do not have the risk budget to support investing their money in offshore equities, but who do have exposure to offshore assets and want their money to work a little bit harder than an investment in cash. The fund is therefore not a one to two month proposition, but a minimum 6 to 18 month vehicle given that there will be some volatility. Investors should expect a higher level of volatility from Global Strategic USD Income than from its local sibling, Strategic Income.

What have we been doing in the fund?

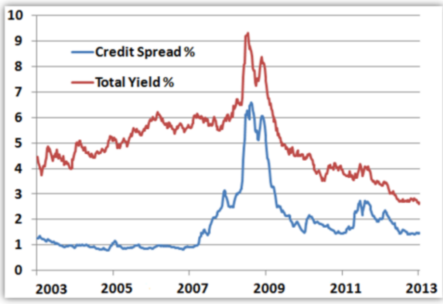
Since inception in January 2012 to end April 2013, the fund has delivered a cumulative return of 9%, or just over 6% on an annualised basis, compared to USD cash that returned 0.08% annualised. However we don't believe this level of outperformance will continue going forward and expect a more normal average annual return to be US dollar cash plus 2%.

Two exceptional tailwinds that supported the fund return include credit markets and listed property. In 2012, credit markets recorded their second best year on record, with sterling credit returning 12%, euro credit 9% and US dollar credit 7% (all returns quoted here are in excess of their respective government bond market returns). We also saw listed property perform very strongly, with global listed property returning 25% and Japanese property 39.1% (in large part thanks to the actions of its central bank). Year-to-date, property was at one point up nearly 20%, however markets have come back in recent weeks, taking the figure to only 5%, which highlights how carefully we need to assess the amount of property we include in a conservative fund such as Global Strategic USD Income.

Can this rally continue and where do the opportunities lie?

As is clear from Figure 5 below, we are faced with a near perfect storm of very low government bond yields and very low credit spreads. Because base rates are so low and credit spreads have reduced significantly, the yield on the US Corporate Bond Index is at an all-time low (2.7%), leaving one with very little capital return potential. While some may argue that current spreads are still a little above where they were in the mid-2000s, one needs to bear in mind that during that period global GDP was very strong and stable, particularly in developed markets. What also concerns us at present is the late-cycle behaviour we see coming through in the raft of low quality issuances, often with poor covenants, and investors buying indiscriminately in their hunt for yield.

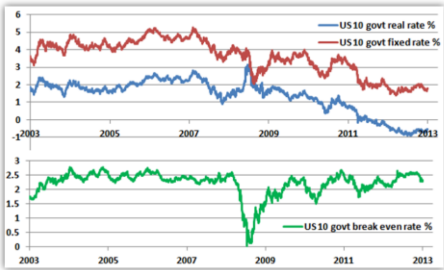
Figure 5: Credit yield and credit spread



Source: BoA-ML

On the government bond side we also have this parallel shift lower in terms of nominal and real yields (see Figure 6), which mean that they can add very little to our portfolio, and at this juncture a 10-year bond carries a lot of duration risk.

Figure 6: Breakeven and real yield

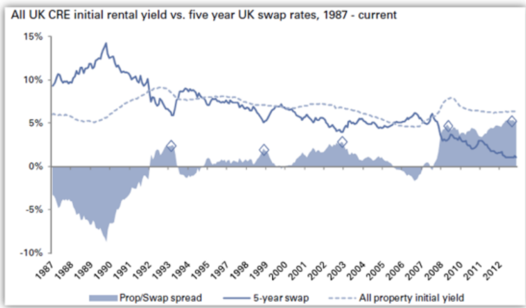


Source: Bloomberg

Where we own bonds in the inflation-linked space, it is at the very short end of the US market (1 - 3 years). While our expected return of 0.6% – 0.7% may not sound like much, compared to US treasuries yielding 0.02%, we believe they are an attractive proposition for the fund.

Looking at property, the shaded area in Figure 7 below shows the difference between bond yields (that have been in decline) and commercial property yields in the UK. This pattern is very similar in Europe and Japan. It is however less flattering in South Africa where the difference in yield is much more compressed. This therefore leaves us with some interesting opportunities in the global property space, but as mentioned before, we are very cognisant of volatility when incorporating property into a lower risk portfolio such as Global Strategic USD Income.

Figure 7: Property yields versus government bond yields



Source: Goldman Sachs

So where do we find the opportunities given what markets have done?

Similar to the domestic market, we believe that a lot of the returns available in international fixed interest markets have now been taken off the table, and we expect to have gone through the peak of the cycle in a year's time.

If we look at the returns delivered by some of our low-risk funds, it has almost been as high as the returns produced by some of our medium-risk funds, but with much lower volatility largely thanks to central bank actions. We however believe the risk is for volatility to pick up, as has been the case in recent weeks.

To summarise our current global fixed interest views, we therefore:

- prefer **a barbell strategy** of lower risk positions coupled with a number of select higher yielding opportunities;
- prefer a **shorter duration** (we hedge out interest rate risk associated with longer dated credit positions);
- **find much less value in corporate credit** as we believe the hunt for yield has given rise to a potential disconnect with economic data and we see plenty of late cycle behaviour;
- prefer **shorter dated inflation-linked bonds** (low duration) over short dated fixed rate government bonds as they provide diversification and protection against uncharted central bank policies;
- are finding **dividend yields on property attractive** versus bonds but are conscious of volatility; and
- hold **very low levels of cash** as short rates are likely to remain low and negative real yielding.