EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

NOVEMBER 2013

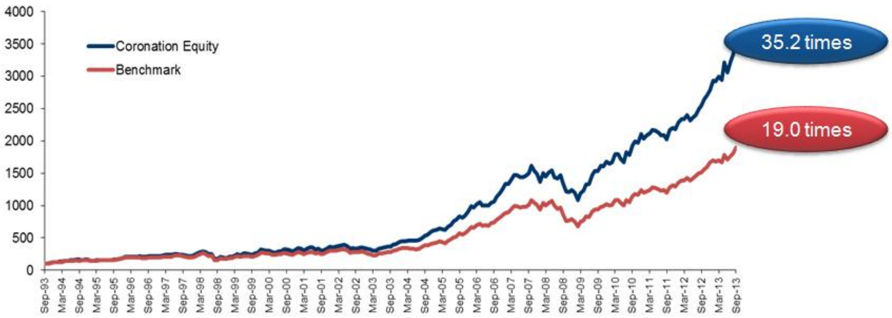
CIO Karl Leinberger recently presented an update on our views regarding a variety of topical investment-related issues.

A COMPELLING LONG-TERM TRACK RECORD

At the end of a year that has been particularly strong, both from a relative investment performance and market return perspective, we believe it is worth revisiting our investment philosophy and remind clients that the short-term alpha (market outperformance) that we generate in our funds can be lumpy. This has been the case throughout our 20-year history and there is no reason why the future should be any different. Any compelling long-term track record inevitably includes both successful and challenging years. Importantly, it is often in the 'challenging' years that the great long-term opportunities are created.

If we look at the track record of our longest-running equity portfolio, launched in 1993, it is clear that the rewards for having remained invested with us over the long-term have been significant: an investment in the local equity market on the day that Coronation opened for business would have grown your money 19 times, whereas a similar investment in our equity portfolio would have grown your money 35 times.

Long-term annualised performance



Performance gross of fees in rands
Source: Coronation Fund Managers as at 30 September 2013

We appreciate that this example does not reflect the experience for all our investors across the various mandates and time horizons. We simply wish to highlight the merits of having the patience to invest with a long-term mindset, whereby less focus is given to the short-term out- or underperformance of your fund and more attention is given to measuring results over meaningful time periods.

DISCIPLINED, LONG-TERM VALUATION-DRIVEN INVESTORS

A question that we are often asked is whether the Coronation investment philosophy is focused on value or growth. Our answer, quite simply, is that we focus on neither; we are deeply disciplined, long-term valuation-driven investors. Operating in a small and limited South African market our philosophy allows us to invest across the full investment universe, in both high-growth shares (where we believe the market's assessment of future earnings is too low) and favour shares which typically have poor short-term prospects.

An analysis of our 20-year track record shows how profitable it has been to own quality, long-term winning businesses at a fair price. And this is the cornerstone of our equity portfolios today - owning quality global businesses that happen to be listed on the JSE (e.g. Mondi, Naspers, SABMiller, MTN and British American Tobacco). We are pleased to report that our investors have benefited enormously over the past two to three years by owning these businesses, and we continue to believe that this is the area of the local equity market that represents the most compelling investment case.

OUR KEY PORTFOLIO-DEFINING VIEWS

As long-term investors our views have remained largely unchanged during the past year. However, given another strong performance by the local market, our exposure to domestic equities, bonds and property stocks has been reduced to abnormally low levels across our multi-asset funds, resulting in an abnormally high cash weighting. While our equity exposure levels remain below average in these funds, we continue to prefer equities to bonds, and within equities, global to local equities.

Below we discuss some of the key portfolio-defining views across our domestic and international funds in more detail.

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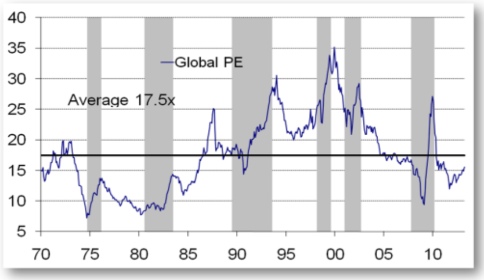
Global assets still offer value

For a number of years we have contended that global growth assets offer value - a view that has worked well for investors in our funds. Notwithstanding the strong performance in recent years, we continue to believe global assets are attractively valued.

A number of smart investors are arguing that all risk assets have been supported by quantitative easing (QE) and that once the stimulus is withdrawn, equities will stop defying gravity. While we agree that these assets have been supported by QE measures, when you ignore the noise you will find that many of the world's best companies are trading at fairly undemanding ratings of 13–18 times earnings, and dividend yields of between 2% and 4%.

The chart below illustrates the average multiple at which global equities has been trading over the past four decades. While global equities no longer offer the compelling value presented during the global financial crisis, they still trade below their long-term averages and, in our opinion, still offer attractive entry points for the long-term investor.

MSCI World trailing PE



Source: Citi Research

Pure domestic assets are expensive

We have also argued for quite some time that pure domestic assets are expensive - this continues to be our view. It is important to understand that the past two decades have not been normal and that the strong returns delivered by domestic asset classes should not be extrapolated into the future.

Bonds remain expensive

Our long-held view that fixed-rate bonds are expensive has, to some extent, been vindicated during the past year. Despite the sell-off, we remain of the view that you expose yourself to the risk of permanent capital loss by being invested in these assets.

South African inflation a longer-term concern

We remain concerned about the long-term outlook for inflation in South Africa. Due to the strength of the rand in recent years price increases have been contained. We now believe that with the significant depreciation in the currency, cost pressures will increasingly creep into the prices we pay for goods and services. In addition, we do not believe that the response from the South African Reserve Bank to inflationary pressures in the economy will be aggressive. Such an approach will ultimately be negative for the long-term outlook for inflation.

Deteriorating fundamentals in South Africa are cause for concern

Corporate earnings, and to a lesser extent GDP growth, have defied deteriorating economic fundamentals and politics over the last five years. Given that the ratings on domestic stocks are much higher than at any time during the last two decades, investors have clearly become numb to these concerns. Corporate South Africa, however, does not operate in a vacuum and in our opinion cannot continue to defend these high earnings bases forever. Some of the reasons behind this view include an extraordinary commodity boom in the base of all domestic businesses that is currently receding; an uncompetitive labour force; and a fiscal and current account deficit (both in excess of 5% of GDP) which place the local currency at risk.

Consequences

Our domestic multi-asset funds therefore continue to remain heavily invested offshore, notwithstanding how well these assets have recently performed for South African investors and despite how much the rand has already weakened over the past two years. Within the domestic equity portions of our funds, we remain heavily invested in the global stocks that happen to be listed on the JSE, despite significant profit-taking in some of our holdings and notwithstanding arguments that these stocks have now become

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expensive. Within the fixed interest portions of our funds, we have very low exposure to fixed-rate bonds and abnormally high cash weightings for the reasons stated earlier.

Our international multi-asset funds, depending on their risk profiles, continue to have high exposure to global equities for the same reasons stated above. We also continue to find value in selected listed property companies, but have no exposure to fixed-rate bonds and only negligible exposure to corporate bonds.

HAS CORONATION BECOME TOO BIG?

It is a fact that all performing managers will attract assets. The important question that you, as an advisor, need to ask is: Do I trust this manager to act in my clients' best interests? At Coronation, we are ruthlessly committed to being an investment-led organisation. We are run by investment people who live and die by their track records.

As a large manager, we enjoy significant advantages:

- we can afford world-class research, and a world-class team;
- we are able to negotiate and conceive bond issues or underwrite rights issues (e.g. the recent Northam Platinum rights issue and private placement by Metair. In the case of Northam, we negotiated the terms and took 100% of the subsequent issue, while in the case of Metair, we were approached to become a significant investor as they regarded us to be a good shareholder of reference given our patient long-term focus);
- we are seen as a shareholder of choice by most management teams and companies in South Africa; and
- as we have indicated earlier in this piece, we believe that our long-term horizon is our single biggest competitive advantage; size forces you to be a long-term investor, making it easier to ensure our actions are aligned with our counter-intuitive investment strategy.

However, we acknowledge that this is not a one-way street, and can provide a number of examples where size did hurt. For example, in 2012 we identified HCI as a great investment opportunity and bought roughly 4%–5% of the company, resulting in a holding of just over 1% in our funds. The share has performed very well this year, and if we had been smaller, we would have been able to build larger portfolio positions before the market reacted. Another example is that of property stocks, which were hit hard in the third quarter of this year. While we bought into weakness, we were unable to build our portfolio positions to the levels that we would have liked.

While the share of the JSE equity market capitalisation that we manage on behalf of clients has increased from 2% to 3% over the past six years, we continue to believe that at current levels we should be able to replicate historical levels of outperformance. We remain convinced that getting our key views right will remain significantly more important rather than any size effect.

We do, however, think that our current South African asset base is above normal and would expect it to shrink over the next few years. The two biggest reasons for this view are:

- We closed our institutional business - three quarters of Coronation's assets - to new clients. Given that the pension fund market is shrinking, we believe that this will have an impact on our assets under management.
- The share of inflows that our retail business attracted over the past three years is abnormal and not sustainable. Once the strong relative performance we have enjoyed inevitably normalises, we believe that our retail flows will also normalise to levels more in line with our asset market share.

A FEW POINTS ON ACTIVE VERSUS PASSIVE

While we are unequivocally active managers, and believe that we can continue to add significant value to our investors' portfolios over the long term, we are not averse to more passively managed money in South Africa. In fact, the more passive money there is, the more inefficient the market will become. This ultimately creates more opportunities for us to buy low and sell high.

We know that all active managers, in aggregate, will underperform the market after fees. This is a mathematical certainty if you assume that the entire market is managed professionally, as the full universe of investors will always equal the return of the market. However, a subset of active managers will always outperform the market. This is not the case for passive managers, 100% of whom will always underperform the market after fees.

Our analysis of the two big 'early' categories in passive funds shows that passive managers who benchmark against the ALSI Top 40 Index have underperformed by 1.11% p.a. over the past 10 years and by 0.94% p.a. over the past five years, while passive managers who benchmark against the ALSI have underperformed by 0.96% p.a. over the past ten years and by 0.56% p.a. over the past five years.

	10-year annualised performance differential vs ALSI Top 40 Index	5-year annualised performance differential vs ALSI
Passive managers who track the ALSI Top 40 Index	(1.11%)	(0.94%)
Passive managers who track the ALSI	(0.96%)	(0.56%)

The problem with true passive investing is that you always end up buying high and selling low - when the first rule of investments is buy low, sell high. For example, when you invest by means of a passive product, you won't own a company like Famous Brands until it has gone up 15 times and has become big enough to be included in the benchmark, forcing you to buy high. The second important point about passive investing is that there is no passive solution to asset allocation, the single biggest challenge in investing. So-called smart beta or enhanced indexation strategies are just different (and arguably weak) forms of active management.

The question that you, the advisor, need to ask is whether you have the expertise to pick winning active managers. It is only when you have some expertise in picking the long-term winners that your clients will enjoy the significant gains from investing with those long-term winners. If you don't, then it may be better to invest your clients' money in a passive product.

RETIREMENT REFORM UPDATE

While much emphasis has been placed on the negative aspects and potential risks relating to the policy and regulatory reform agenda, we believe that there is also quite a bit of good news that advisors need to be aware of.

A very important point to understand is that reform processes, much like financial markets, are cyclical in the way that the intensity of the agenda changes over time. The investment and savings industry currently faces a very intense reform agenda, firstly as a result of reforms put in place following the global financial crisis in 2008 and secondly as a result of the reform agenda put in place by a newly-elected South African government in 2009. The key point to make is that five years into the post-global financial crisis era we are unlikely to see any additional agenda items emanating from this source added to the already proposed interventions in the marketplace. We also expect that following the 2014 South African elections, there will be no change in government, which means that the current minister of finance, Pravin Gordhan, will focus on wrapping up the priorities initiated during his first term, instead of adding any new or dramatic items to the agenda.

One of the most positive recent developments was an announcement by the Financial Services Board regarding the focus areas of their soon-to-be-released discussion paper, the *Retail Distribution Review (RDR)*. The key focus areas of the RDR will be:

- to ensure that customers pay advisors fees for investment services rendered to them, rather than advisors earning commissions paid by product providers for business placed; and

- ensuring that advice presented as independent is truly unbiased from product provider influence.

The regulator recognised in their update that the prevailing business model in the platform and unit trust industry, where product providers collect asset-based fees agreed between clients and advisors from invested assets, is consistent with this objective. The review is therefore expected to have relatively little impact on advisors using the standard industry model.

For a more detailed discussion on this topic, kindly click here to view the webcast.