# EXECUTIVE SUMMARY
## CONVERSATIONS WITH CORONATION

AUGUST 2014

### GLOBAL OUTLOOK IS SLOWLY IMPROVING

The US is in recovery mode, with all the key metrics moving in the right direction. Quantitative easing should be phased out by October of this year, after which the focus will shift to the debate around raising interest rates.

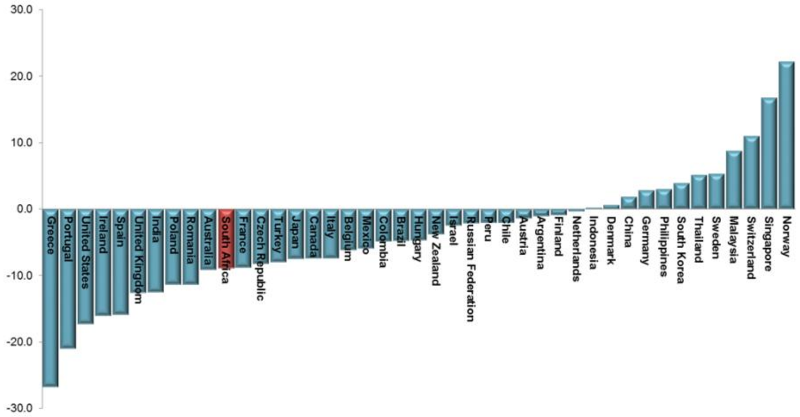
Europe has stabilised with very few countries remaining in recession. Deflation has emerged as the greatest threat and, consequently, more monetary stimulus is expected on the continent. The UK, whose economy is more closely aligned with the US, should be the first of the developed countries to hike rates.

China remains a concern. What is clear is that growth has slowed from the heady double digits to a more sustainable 6% to 7%. The nature of the growth is also shifting from being heavily reliant on investments and exports to being more balanced with consumption taking a larger slice of the pie. Workers are being paid more and there are efforts to clean up air pollution. But social responsibility spending comes at a cost. Chinese goods will not be as competitive as in the past 20 years. Reforms to address inefficiencies and corruption remain positive for the economy in the long run.

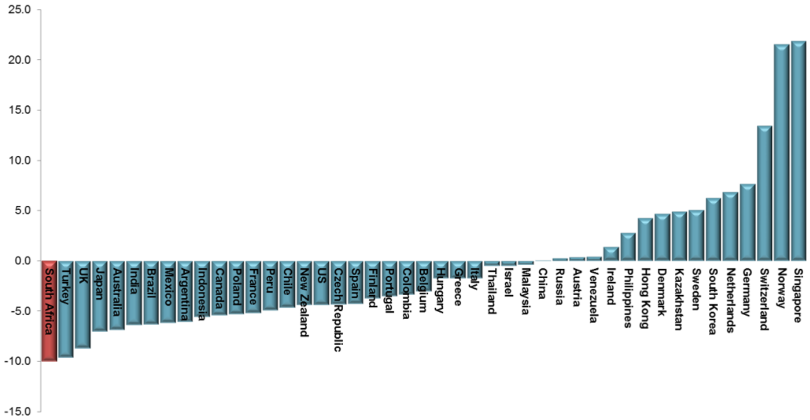
### … BUT SOUTH AFRICA'S OUTLOOK IS GRADUALLY DETERIORATING

Unlike many other countries, South Africa has not improved its fundamentals following the global financial crisis. In 2009, our twin deficits (that is the fiscal deficit plus the current account deficit) were fair compared to many developed economies. Those countries hiked taxes or cut fiscal spending, but South Africa did not take the tough decisions required to deal with the problems of slow growth brought about by the global financial crisis. As a result our twin deficits are now among the worst in the world.

**Twin deficits, 2009**




**Twin deficits, 2014**




*Source: IMF*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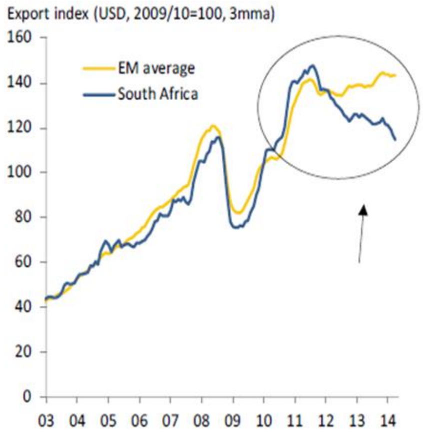
It is on the export side, in particular, that South Africa failed miserably. Rising production costs rendered our exports less competitive and the situation was worsened by prolonged strikes in many of our export industries.



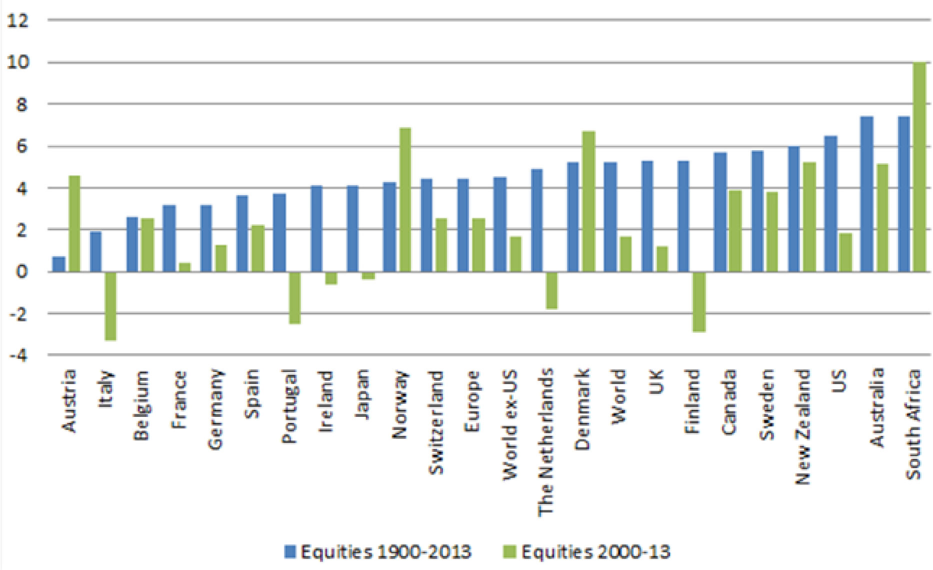

*Source: Emerging Advisors*

The weak fiscal position and balance of payments problems contributed to the dramatic weakening of the rand, which fed through to higher inflation. The downgrade by the rating agencies was the inevitable consequence.

## TEMPERING EXPECTATIONS

As can been seen from the following graph, South African equities have delivered better annualised returns than any other market over the long term. The local market has had a particularly great run for the past fourteen years, but this performance is exceptional and probably won't be repeated. Investors are cautioned against extrapolating past performance as the expectation is for lower returns in future.

**Real annualised returns (%) on equities, 1900 - 2013**




*Source: Credit Suisse*

The domestic equity market is looking expensive, with the JSE's price earnings ratio close to 19 times, compared to the past 55-year average of 12 times. Historical data shows that investors who bought the market at an average of more than 17.5 times, earned a negative average return in the following year. Foreign assets appear comparatively cheaper. However, it should be noted that while the slumping rand bolstered returns from these investments in the past five years, this cannot be relied upon year after year.

Income assets are also likely to deliver a weaker performance, with cash already yielding a negative real return. When bonds and preference shares are taken into account, inflation plus 2% is the best return to be expected from an income investment for the foreseeable future. While equities may yield slightly more than that, we expect much greater volatility in returns.

## INVESTMENT STRATEGY: KEEPING IT ON THE FAIRWAY

Amid demanding market valuations and increasing insecurity, we are reducing risk and diversifying across different and less-correlated asset classes.

Our approach with Coronation's flagship income and growth funds, Capital Plus and Balanced Defensive, is very disciplined and focused on valuations. This has contributed to strong long-term returns despite the low-risk profile of these funds. Balanced Defensive investors have earned an average return of 13.8% p.a. over the past five years, compared to the fund's benchmark of 8.8%. Capital Plus yielded annualised growth of 14.6% in the same period, while its benchmark grew 9.6%. However, these return levels may not be sustainable if the market environment becomes less benign.

We continue to diversify risks across asset classes and are deploying different tools, some of which were previously inaccessible. These include exchange traded funds (ETFs) with exposure to physical metals, particularly platinum, palladium and gold. This exposure is relatively uncorrelated to other assets. Palladium has done particularly well for the funds.

Another priority is identifying investments with skewed payoff profiles, for example convertible bonds. An ideal instrument for our income and growth funds is the Aveng convertible bond. A five-year bond with an interest rate of more than 7%, it also offers an equity kicker; depending on share price performance, the bond can be converted into equity, which will allow investors to participate if the equity performs well.

For the first time in the past five years, Capital Plus and Balanced Defensive are also investing in government bonds. The yields on offer aren't substantial, but the low levels of risk are appealing. Despite offering a negative real return, cash holdings have also been increased. We believe in having cash on hand in order to invest in favourable opportunities should it arise. With Capital Plus, we also use put options to protect the fund's exposure to domestic equities. The cost of this kind of 'insurance' acts as a drag on returns, but we consider it essential in the current market environment.

While local equities are expensive, both Capital Plus and Balanced Defensive have invested in some 'fairway shares' that have defensive qualities and offer very sound business cases:

- Old Mutual is a particularly suitable investment for the funds, with reasonable upside and very limited downside. The business has been dramatically de-risked and management incentives have changed substantially. Previously, growth was pursued in new geographies. Now management is content to return capital to shareholders and dispose of assets, which result in special dividends from time to time.

- Pioneer Food Group is seeing a rejuvenation following the appointment last year of Tiger Brands executive Phil Roux as its CEO. While it has a portfolio of leading and high-potential consumer brands, the group has in recent years lagged some of its competitors. Its state-of-the-art factories are now being better utilised and opportunities elsewhere on the continent can provide significant earnings growth. Pioneer is trading at our normal assessment of 14 times earnings.

- Spar has an attractive, very defensive business model where store owners (and not corporate managers) run outlets and are responsible for capital investments. The company has remarkably stable margins, high return on equity ratios (ROE) and excellent free cash flow (FCF) conversion rates. Spar pays out two thirds of its earnings.

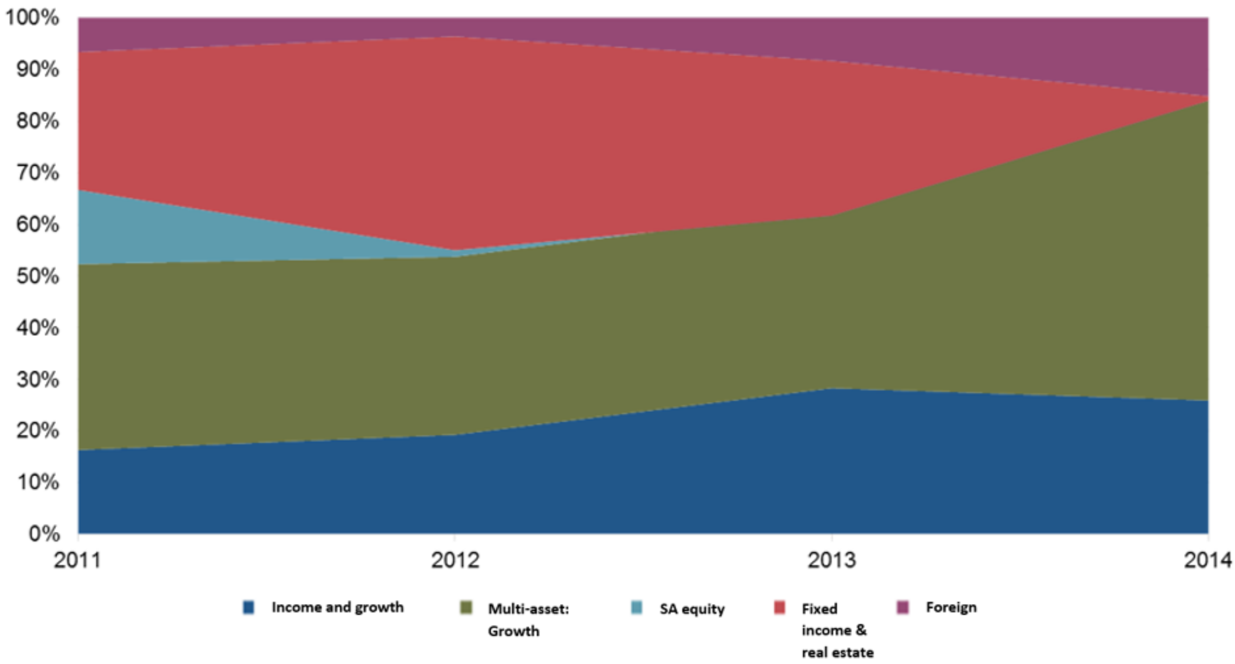
We continue to prefer global equities, however. The current price earnings levels for these assets are not historically cheap, but less demanding than domestic equities. The one caveat is that recent returns from these investments have been boosted by the weaker rand. This tailwind will probably diminish and the recent returns in all likelihood won't be repeated.

For a more detailed discussion on the current portfolio holdings of the Coronation Capital Plus and Balanced Defensive funds, please refer to the webcast (Password: July2014).

### RISK AND RETIREMENT

The extraordinary returns in recent times have contributed to a welcome decline in the average living annuity drawdown rate - from 6.8% in 2012 to 6.6% last year, according to Asisa. On the other hand, the benign environment also whet risk appetite, which may be concerning. As equity returns remain strong, a significant number of retirement investors seem to have taken on additional risk. In 2012, 19% of annuity portfolios did not comply with Regulation 28, having greater-than-permitted exposure to risky assets. In 2013 that increased to 25%. This is consistent with the cash flow trends seen across the unit trust industry, as shown in the graph below. The inflow to fixed interest funds has dwindled and investors have seemingly skipped the next risk bracket (income and growth funds) to invest in multi-asset growth funds instead.

**Share of net flows by mandate type**



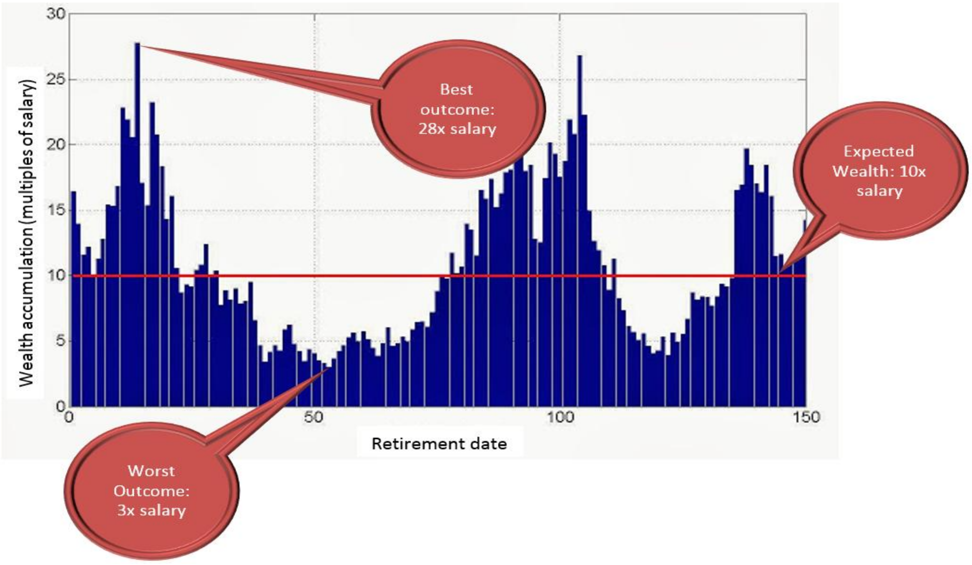

*Source: Morningstar, Asisa, Coronation Research*

The big surge in demand for these high-equity portfolios, which now represent a substantial share of inflows, is worrying and may also be the result of a false sense of security among investors. The most popular balanced funds at the moment are, after all, those that performed relatively well during the financial crisis. While equity markets declined by 20% in 2008, these funds only fell by around 10%. Investors may expect the funds to repeat this performance during the next slump. However, there is no commitment from any of the managers of balanced funds that returns will be smoothed to manage volatility through bad years, which makes larger participation in market losses possible in future crises.

In contrast, income and growth funds offer reduced volatility relative to traditional balanced funds. These funds aim to achieve a balance between reasonable long-run expected returns and near-term capital stability. The latter is a particularly relevant consideration for the retirement class of 2014 and 2015, who will be vulnerable to any possible market loss in the coming months.

Consider the following example: 151 investors all save 15% of their income at the end of every year for 30 years. All the investors save exactly the same amount (in real terms). They invest in an equity-like asset, which on average returns 7% real per year, but with a standard deviation of 20%. Their expected compound annual growth rate is 5% per year. The only difference between the investors is that each person starts saving exactly one year later than the previous investor. This means that each investor's investment term overlaps for 29 out of 30 years with the investor who started saving in the year just before or after them. However, when a simulation of market movements is applied, their outcomes are hugely different:

**The birthdate lottery**




*Source: wpfau.blogspot.com*

This simplified example illustrates that if a retirement date coincides with an adverse market environment, the impact on accumulated savings could be devastating. Investors are also much more vulnerable to a market loss late in the accumulation cycle. Investors close to retirement should therefore take note that the current environment argues for a more conservative asset allocation. Our income and growth funds offer reduced volatility relative to traditional balanced funds.

## REGULATORY UPDATE

### Retirement reform

The reform process is stalling amid social disagreement about the next step: the compulsory preservation of accumulated retirement benefits when a fund member leaves an employer. This is the key reason most employed South Africans don't have adequate retirement savings. But organised labour argues that access to these savings is part of a worker's right – and if given up, needs to be traded for something else.

They are effectively arguing for an expansion of the social wage or the social safety net. Given South Africa's fiscal quandary, this is highly unlikely to be achieved. Until that impasse is resolved, we are unlikely to see any further progress. In general, there is increasing uncertainty about whether the retirement reforms process, currently in its tenth year and directed by the third minister of finance, may end up losing steam.

However, two key changes which are broadly positive for the financial advisor community will still take effect next year. From March 2015, retirement annuities will offer exactly the same tax incentives as occupational pension funds. Also, lump sum access in a provident fund will gradually be phased out. The legislative process for individual savings accounts (specialist savings accounts outside of the retirement environment) should also be completed by March next year. The first of these products should be launched in about a year's time.

### Retail Distribution Review

The formal discussion paper on this issue is still awaited. The current model for client-agreed advice fees most likely won't be altered. The main focus is expected to be on other parts of the value chain: the risk environment and product provider behaviour.

One issue that will be addressed concerns platform rebates. The regulator will probably insist that any reduced fees be paid to benefit the client's account. Platforms also won't be allowed to augment revenue in an opaque manner.

For fund managers, performance fees and the level of disclosure provided about these fees should be addressed. Industry has acknowledged that there is scope for improvement and fund managers should establish best practice guidelines on performance fees towards the end of the year. This may include, for example, that reporting is standardised and that performance fees are only charged on returns net of fees.