

PORTFOLIO MANAGER COMMENTARY

2011 was an eventful year. In March, global markets were first jolted by the Japanese earthquake and tsunami, but then recovered. The dysfunctional political process in the US regarding the country's debt ceiling led to the first downgrade of US debt in history, and counter intuitively was followed by a decline in equities and a rally in bonds. At the same time, the European sovereign debt crisis reignited fears of a global recession, while the political landscape of North Africa and the Middle East was permanently changed by the events of the Arab Spring. In China signs of a slowdown in the property market led to more caution on global commodity stocks.

Despite the volatility and oscillations caused by all these events, the FTSE/JSE All Share Index ended the year essentially flat. The meagre total return of 2.6% for the year all derived from dividends. In the final quarter of the year the index was up 8.4%.

Fixed interest assets performed better over the course of the year, with the All Bond Index delivering 8.8%, preference shares 8.4%, inflation-linked bonds 13.1% and property 8.9%.

International equity markets, however, had a poor year, with the MSCI World Index returning -5% and the MSCI Emerging Markets Index -18.2% (both in US dollars). For South African investors, the 22% weakening in the rand over the year helped soften the blow, and resulted in decent rand-based returns. Measured in dollars, the performance of our local assets were much worse than those of developed markets and slightly better than the emerging markets index.

The fund delivered a return of 4.3% for the year, below its benchmark of inflation +6%. This was mainly due to a relatively high equity weighting and the low returns on offer in local assets – none of the domestic asset classes returned much more than 6% above the average inflation rate over the year (6.4% estimated). The offshore component of the fund contributed to the return for the first time in a number of years. Longer-term performance is still satisfactory: over the last three and five years, the fund delivered compound returns of 14.3% and 7.8% respectively.

Equities are the only asset class that will enable the fund to exceed its inflation benchmark in the medium term. The years in which equities do not outperform inflation by a significant margin will always be challenging for the fund. The low returns on offer this year was unfortunately compounded by our poor stock selection within domestic equities. The equity portion of your fund delivered a return below that of the major market indices for the year. This was mainly caused by our position in construction stocks and more cyclical companies like Sappi and the platinum miners.

The domestic equity market of 2011 was characterised by strong performances from the relatively defensive industrial sector and underperformance by the more cyclical sectors like resources and construction shares. At current prices, we believe cyclical companies are relatively cheap and price in a very poor outcome. As is often the case, we have entered these companies too early, but we still expect them to provide the fund with good returns going forward. In most cases we used the weakness in share prices to add to our holdings.

The put protection we bought for the fund last year also had a negative impact on our equity performance. When equities perform well, this insurance premium matters less relative to the returns generated, pays off handsomely when the return on equities is negative. In 2011, the cost of protection was more keenly felt as the cost relative to the return on offer was relatively large. We still believe that protecting the equity part of your portfolio is prudent and should pay off in a scenario where equity markets perform poorly. A large part of the cumulative performance of investors over time is by avoiding big capital reductions in tough markets.

The past year was only the second in the last 10 years during which international equity markets outperformed domestic ones when measured in rand. This certainly contributed to the performance of the fund, with the international portion of the fund outperforming the MSCI World Index. Much of last year's performance was driven by the significant weakening of the rand and we have hedged back a small part of our offshore currency exposure into rand. We continue to prefer global equities to domestic assets and are close to the maximum allowed weighting.

We remain nervous holders of South African listed property, mainly because of the poor returns on offer in the cash market. The same argument applies to our inflation-linked bonds, where we probably would have been sellers of these instruments had the alternative investments offer more attractive returns. These instruments should also serve us well if our fears of increased inflationary pressures in South Africa play out. We continue to avoid government nominal bonds as we remain negative on global nominal bonds and the potential inflationary pressures referred to above.

The table below shows the performance of some of the assets classes available to investors over the last year, decade and century:

Table 1: Total return for various asset classes over time

	2011	2000-2010	1900-2000
SA equities	2.6%	18.1%	11.6%
SA bonds	8.8%	11.7%	6.2%
SA inflation	6.4%	6.3%	4.8%
Global equities (\$)	-5.0%	2.3%	9.0%
Global equities (R)	15.8%	1.5%	n/a
Global bonds (\$)	6.4%	7.0%	4.4%

Source: *Triumph of the Optimists*, Coronation calculations

We have been warning investors for some time that they should expect weaker returns in future than what they have become accustomed to. The table above should remind us that the last 10 years were unusually fortuitous for domestic assets (and poor for global equities) in the context of longer-term history.

Lower returns will make our mandate more challenging. We are acutely aware that the assets entrusted to us by clients are a critical part of their retirement nest egg. In future, with returns harder to come by we will continue to work hard to generate returns within acceptable risk parameters. We urge clients to be realistic about future returns.

Portfolio managers

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