

## PORTFOLIO MANAGER COMMENTARY

The fund has outperformed its benchmark by 1.3% p.a. over a rolling 3-year period (14.9% versus 13.6% p.a.) and by 0.8% p.a. over a rolling 5-year period (9.5% versus 8.7% p.a.). The fund is one of the top performing funds in its sector over all meaningful periods.

The past year was characterised by periods of extreme volatility. In the first half financial markets had to digest the implications of the political unrest in North Africa and Middle East as well as a devastating earthquake and risk of possible nuclear meltdown in Japan. The second half was dominated by continued political wrangling which saw policy makers fail to resolve the ongoing Euro crisis. This fuelled uncertainty as global investors reduced exposure to growth assets.

The global economy and financial system remain unbalanced and are being distorted by unprecedented monetary and fiscal stimulus. The precarious state of the global economy has a bearing on market sentiment. In volatile times, emotion often trumps reason resulting in investors mispricing assets. As a valuation-driven, bottom-up stock-picker, Coronation remains resolute in its philosophy of investing for the long term. While this may result in periods of short-term relative underperformance, we believe it will produce superior returns for our clients over the long term.

Given the current global and domestic economic outlook, equities remain our preferred asset class for producing inflation-beating returns. Following the panic that consumed markets in the third quarter of 2011, equity markets recovered in the final quarter which created the opportunity to reduce exposure to what we consider to be a neutral equity exposure. The All Share Index is currently very near to an all time high and is certainly not pricing in a sharp correction in the global economy. This coupled with our view that domestic equities are fairly valued, does not justify higher exposure. Global equities on the other hand are discounting some probability of a global downturn. Domestic equities have outperformed global equities significantly over the last decade (15.2% p.a. for the All Share Index versus 0.1% p.a. for global equities in rand terms). We remain of the view that global equities are far more attractively valued than domestic equities. This view was vindicated in 2011 with the MSCI World Index (in rand terms), comfortably outperforming the All Share Index by 13% for the year (15.8% for the MSCI World Index versus 2.6% for the All Share Index). Our domestic balanced funds remained close to their 25% offshore limit for the duration of the year.

After a prolonged period of strength, the rand (together with other emerging market currencies) experienced a sharp sell-off towards the end of the third quarter. Given our long-held view that the currency was overvalued, our rand hedge investments such as MTN, SABMiller and British American Tobacco contributed to overall equity performance. We continue to favour global businesses that happen to be listed in South Africa. They remain attractively valued relative to pure domestic businesses and are diversified across numerous geographies and currencies. At the end of 2011, approximately 63% of our equity portfolios were invested in rand hedge counters.

The All Share Index returned 8.4% for the quarter. Industrials were the best performer with a 9.2% return. Financials returned 8.7% and resources lagged with a 7.3% return. Resource stocks have now underperformed financials and industrials over a 3-year period. Having remained underweight resources for most of the year, we moved slightly overweight in our equity and balanced funds.

Although most commodity prices remain high, we believe that resources currently offer value, with selected resource shares trading at less than 10 times our assessment of normal earnings. The great imponderable impacting commodity prices and therefore the valuations of resource shares remains demand from China. China has been the single largest consumer of commodities, responsible for, on average, approximately 40% of global demand for most commodities (and even higher in the case of iron ore where China constitutes 60% of global demand). The Chinese economy is extremely unbalanced having been driven by significant investment in infrastructure and very little domestic consumption. The country is also in the process of attempting to cool an overheated property market. Any Chinese hard landing will have dire ramifications for commodity prices and consequently, the pricing of resource shares. It is for this reason that we remain only marginally overweight. Our preferred resource holdings are Sasol, the diversified miners (specifically Anglo American) and Mondi Limited. We remain underweight gold shares as we believe they are overvalued based on our assessment of normal earnings. We are also concerned over declining grades and enormous cost pressures faced by these businesses (labour, electricity and water).

Banks returned 7.8% for the quarter, underperforming other financials. Banks have been very poor performers, however we continue to hold our overweight position on the basis that valuations are attractive at 9 times our assessment of normal earnings and price-to-book ratios of 1.7 times. We believe earnings are low as a result of low net interest margins and high bad debts. This, coupled with a low rating, represent a highly attractive investment proposition.

In contrast, we remain concerned over the earnings base for the average industrial company, especially consumer-facing businesses. These businesses have benefitted from significant tailwinds such as falling inflation, declining interest rates, an emerging middle class and significant social grants. These benefits are in the base, which will make it challenging for these businesses to defend and grow off their current earnings. Consequently, we own very little retailers, other than Woolworths and Mr Price and remain defensively positioned. We continue to find value in selected small caps.

The bond market returned 3.5% for the quarter, outperforming cash which returned 1.4%. We believe the real returns from cash and bonds are likely to be relatively poor over the long term, both from a local and global perspective. Short rates are likely to remain lower for longer and we believe that the significant financial and monetary stimulus thrown at the global economy will ultimately translate into higher inflation in the future. In South Africa, inflation has already breached the upper limit of the Reserve Bank's target range of 3% - 6%. As a result, we had very little to zero exposure to domestic and global government bonds in our portfolios throughout the year. Instead, we have held on to our significant holding in inflation-linked bonds and maintained good exposure to local corporate bonds.

Listed property enjoyed a good quarter, returning 3.7%. At current levels, property yields remain too low and no longer offer value, especially in light of the once in a life time bull market enjoyed by property over the last decade.

It remains our view that the global economy will face an extremely difficult period in the years ahead. The investment environment is therefore likely to remain volatile and challenging for the foreseeable future. Global equities, however, discount many of these concerns and we believe, offer good value. In an environment fraught with uncertainty, we remain committed to our investment philosophy of investing for the long term.

**Portfolio managers**

Karl Leinberger and Quinton Ivan