CORONATION PREFERENCE SHARE

CLASS A as at 31 March 2012

CORONATION FUND MANAGERS

PORTFOLIO MANAGER COMMENTARY

After a rollercoaster ride in the preference share market this quarter, the fund returned a positive 0.6%, taking its one-year return to 8.7%. Over three years, the fund has achieved 9.8% per annum which is a pleasing result when compared to after-tax cash returns over the same period and also in light of the volatility within the asset class in years gone by. Much of this volatility is due to low levels of liquidity and of course the uncertainty that existed up until the implementation of dividends withholding tax.

This year's budget announcement in February finally provided full clarity around the dividends tax as it pertains to perpetual preference shares. As of 1 April 2012 the dividends on perpetual preference shares are subject to a withholding tax of 15%. The quantum of this tax came as a surprise as the market had been expecting dividends to be taxed at the same rate as STC had been levied, i.e. 10%. As a result, the sector initially sold off as investors' disappointment filtered through, and by end-February the monthly performance on the fund was -3.98%.

During the quarter, preference share issuers reaffirmed their commitment to gross up the yield on their preference shares for the STC savings they will receive following the change to dividends tax. The level of the gross up, however, varied between 10% and 11.1%, and not the full 15% dividends tax announced. As this clarity filtered into the market, we saw a recovery in preference share prices as good value was identified during March, resulting in a monthly return for the fund of 4.33%.

Going forward, we are aware of the risk that the level of dividends tax may change and believe that issuers of these instruments are unlikely to adjust future yields in compensation. However, when it comes to changes in tax rates, this risk exists for all other instruments and is not unique to the preference share market. We continue to believe that current yields remain attractive when compared to cash yields after taking the marginal individual tax rate into account and offer great value for an investor seeking yield. The resultant effective pre-tax yields on perpetual preference shares are currently around 7.1% on the bank preference shares and between 8.3% – 9% on the corporate preference shares compared to approximately 5.5% available on cash investments.

After the grossing up in yields, perpetual preference shares have become more attractive for non-taxable investment vehicles and therefore are likely to be well supported by the pension funds given their non-taxable status. The full grossed up dividend is paid to the pension fund before any deduction of the 15% dividends tax. Individuals will however receive the net dividend after a deduction of this tax.

Preference share issuance has remained fairly strong during the quarter, with African Bank and PSG continuing to tap their existing shares. Investec Bank Ltd will be issuing further INPR shares to the market during April. Under the proposed Basel III rules perpetual preference shares will no longer qualify as Tier 1 capital for South African banks as they do not have loss absorbing capacity. Perpetual preference shares will therefore be phased out of the bank capital structures over a ten-year period. This is likely to impact the level of issuance of the current perpetual preference shares going forward.

The fund has maintained its higher weighting to the bank preference share sector given their good risk/return balance and greater liquidity inherent in this part of the market. Corporate preference shares are smaller by market capitalisation and therefore much less liquid, but do offer some yield pick-up over banks.

The fund continues to focus on achieving a solid long-term performance by identifying the best value available in the preference share market over time.

Portfolio managers
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