Fixed interest update

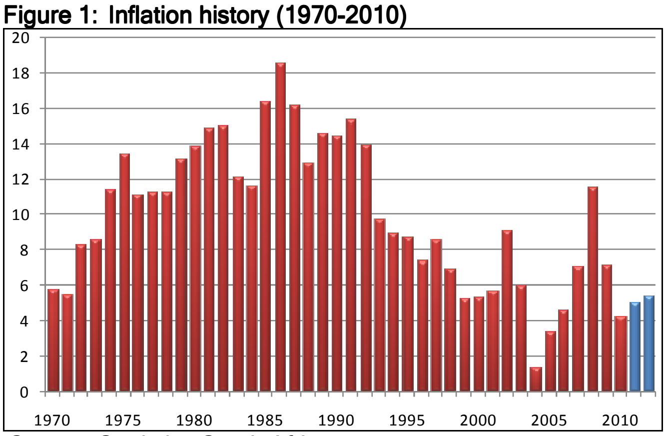
May 2011

Current economic/fixed interest outlook

South Africa's overall inflation (CPI) has come down quite sharply over the past ten years compared to historical levels (see Figure 1 below), averaging about 6% during the past decade versus 10% in the 1990s and 15% in the 1980s. The key reason for this is the introduction of inflation targeting by the South African Reserve Bank (SARB) in 2001. At its most recent announcement in April 2011, inflation was sitting at 4.2%.

While it may be tempting to extrapolate this low level of recent inflation into the future, we believe that we have reached the bottom of the cycle and are likely to see inflation breach the upper limit of the SARB's target range of 6% by September of this year.

Figure 1: Inflation history (1970-2010)



Source: Statistics South Africa

Our expectation is based on pressure building from a number of factors, predominantly rising global food and oil prices. While the strong rand has offset a large part of these underlying pressures, we believe the currency is currently about 20% overvalued and that any unwind will have major consequences for inflation.

Moreover, policymakers have to date remained on the side of caution by keeping interest rates at their lowest level in three decades at 5.5%. We however also believe that the next move in interest rates is up, either later this year or early 2012, given the building inflationary pressures.

To protect our clients against the pickup in inflation, what instruments or asset classes within the fixed interest universe are we implementing in our portfolios?

1) Inflation-linked bonds

Approximately 20% (R255 billion) of the debt in issue in South Africa is in the form of inflation-linked bonds (ILBs). We currently hold a substantial amount of ILBs across our range of funds, which we accumulated during a time of falling inflation (i.e. when they were attractively priced yet unattractive to many investors). While some have questioned the timing of our purchases, we feel comfortable knowing that once inflation is on the rise availability of these assets may be very tight.

The reasons for holding ILBs include:

- Diversification – ILBs often do not behave like any other asset class and are therefore great diversifiers in long-term, multi-asset class portfolios.

- Protection against inflation – If held to maturity, ILBs offer protection against inflation over the long term. Real yield movements can however cause short-term capital fluctuations.

- Composition of investors – Many of our clients are investing for retirement or are already in post-retirement funds – as such we need to protect against inflation.

- Volatility – ILBs are less volatile than most other asset classes.
- Liquidity – The issuances of ILBs have increased, but remain quite limited particularly corporate ILB issuance.

2) Floating rate notes

While most bonds have fixed coupons that are set on the bond's first issue, a floating rate note (FRN) has a variable coupon. This means that the bond's coupon will move (up and down) to reflect changes in market rates. Given that the coupon payment on an FRN depends on the level of money market interest rates and, on average, offer a yield pick-up of 0.7% over prevailing market rates, it makes sense to favour these instruments when interest rates start to rise (as we expect them to do).

3) Corporate credit

The corporate credit market saw a significant compression in yield as issuers' balance sheets improved, contributing positively to those funds where these assets were held. In an improving economy – a rising interest rate environment – these spreads may compress even further. Hence, we maintain significant exposure to good quality corporate bonds across our fund range, trading at what we believe to be attractive spreads over government bonds, of which we hold very little.

4) International corporate credit and listed property

Another means of enhancing returns/increasing portfolio efficiency over time is the inclusion of international fixed interest exposure. For example, the Coronation Strategic Income Fund can have 10% international exposure - currently at 6.7%. Two very important points on our offshore exposure is that we only invest in assets that we know, therefore predominantly South African companies issuing debt in overseas markets, and we do not compromise on yield when investing in these assets.

International corporate credit

A number of South African companies are issuing debt in markets such as the US and the UK, typically to diversify their funding base or as a result of their already having operations and liabilities in that country. However, if as an issuer you are not known in that market, you will pay a premium in terms of yield. As South Africans, we know the companies issuing in foreign markets well and are able to put our knowledge to work, identifying the good buying opportunities for our funds.

Standard Bank for example has issued subordinate debt* in the US at a yield of 9% to its first maturity in 2016. Compared to holding US Treasuries of a similar maturity at 2.2%, the Standard Bank yield strikes us as offering very good value. Given that Standard Bank is currently on a cost-cutting exercise, we believe the bank will be buying back this debt in 2016 rather than continuing the debt into perpetuity. Should Standard Bank decide not to repay its debt in 2016, we will still earn a yield pick-up of more than 3% over US interest rates when the coupon resets - which from our point of view remains good value and a good investment for our portfolios.

Offshore property

We also invest in offshore property. The Coronation Strategic Income Fund currently holds about 1% in offshore property in total which consist of Capital Shopping Centres and Capital & Counties (ex-Liberty International) in the UK as well as Growthpoint Australia. In both instances we believe these assets offer long-term earnings upside.

*To learn more on how we address this changed environment in our flagship fixed interest fund, Coronation Strategic Income and the tools we are putting to work, please download Mark le Roux's **audiocast** or click on the **Corolab** included in this mailer.*

**Subordinated debt is a lower-rated debt (ranking behind senior debt), typically issued by banks to boost their capital adequacy levels. Subordinated debt differ from normal (senior) bonds in that they have a split maturity - a legal maturity of at least ten years and a first optional redemption date after at least five years. In essence investors sell the banks a call option (an option, not a duty, to redeem the bonds at the first optional redemption date) which the bank pays for through a higher initial yield.*