Year-end round-up

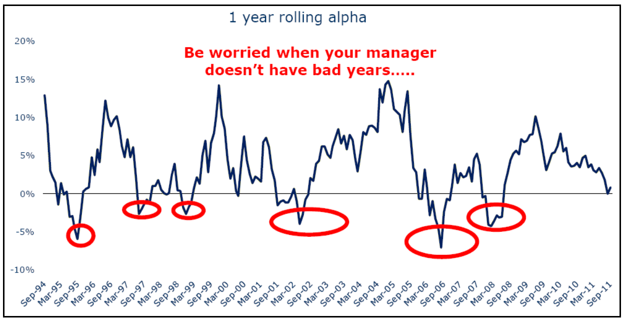
Executive summary from Conversations with Coronation held in November 2011

An update from Coronation

Long-term investing

The nature of our business requires clients to entrust their hard earned capital to us; often for periods of 20 years or more. As such we believe they need to understand our investment philosophy which is primarily aimed at generating returns over the long term. The following graph illustrates the alpha that we have produced over rolling 12-month periods since the inception of our business in 1993. What is clear is that over the past 18 years there have been at least six fairly prolonged periods during which we have underperformed the market.

Coronation Fund Managers: 1-year rolling alpha



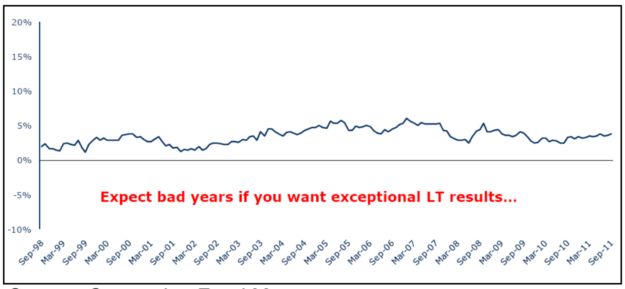
Source: Coronation Fund Managers

Looking at the graph, one would instinctively want to say that the periods where the graph lies above the line is where Coronation was getting it right, and the periods below the line where we were getting it wrong - when in fact the inverse applies. The mental leap one has to make is that where the graph is lying above the line is where we were reaping the rewards from the decisions made during the periods of underperformance, as every single period of underperformance was followed by a period of strong outperformance.

What we would like our clients to understand is that if markets misprice assets and you invest with a long time horizon as we do, you should expect periods of underperformance from your manager. Expect them to be pretty meaningful and for them to turn up fairly regularly as we believe it is during these periods of underperformance that one is 'sowing the seeds in the bare, dry earth for the rains to come'.

Alpha over the past 18 years has been very lumpy and we expect this to be the case over the next 18 years. For investors with a one year time horizon, this would have meant a very rocky ride. However, if you look at the same track record, but adjust your time horizon to a meaningful 5 years, there hasn't been a single day on which our clients have had to endure negative alpha. In fact, it has always been an impressive outperformance of between 2% and 5% (see graph below).

Coronation Fund Managers: rolling 5-year alpha



Source: Coronation Fund Managers

Our message to clients therefore is to hold us accountable, but only over meaningful periods of time. For periods short of 5 years, you have no way of knowing whether it is the manager's skill or luck that has delivered the returns.

The Coronation Client Charter

Early in 2010 we introduced the Coronation Client Charter, a formalised framework for evaluating our overall performance as an investment provider. The charter states that:

- We strive to always put clients first
- We have an unwavering commitment to the long term
- We focus on producing top performance over all meaningful periods
- We are uncompromising about ethics

Two tangible examples of how we have lived up to the charter this year include:

1) *Fee reductions in two of our biggest flagship unit trust funds*

The fee cuts in the Coronation Strategic Income and Coronation Capital Plus funds are in line with our reading of the current investment environment, where investors should expect a combination of higher inflation and lower returns from the domestic asset classes in the decade ahead. In the case of Capital Plus we reduced the performance fee cap from 1.5% to 1%, while we reduced the fee applicable to Strategic Income from 1% to 0.85%.

In an environment of higher inflation and lower returns this means that fund managers, platforms and advisors will all need to take a hard look at the fees they charge and clients will need to adjust the drawdown levels on their living annuities to sustainable levels.

2) *Closing our business to new equity clients in the pension fund space*

In May we announced the closure of our business to new equity clients in the pension fund space. As one of the largest managers of third-party assets in the country, our first priority is to consistently deliver the best possible returns across all client mandates. To achieve this it is imperative that our business does not grow to a level that impedes our ability to outperform the markets. While this close does not affect our unit trust business, it will have a meaningful impact on the short-term profitability of our business. It is a decision taken in the interests of our clients, enabling us to continue to live up to the commitments stated in our charter.

Our current market views

We cannot forecast the markets, but we can provide some perspective on the current market environment:

1) Don't expect low interest rates to bail us out, we are in a balance sheet recession

Deleveraging is going to be a feature of the OECD countries for a very long time. This deleveraging is not just restricted to governments, the banks or consumers - all three stakeholders in the system are deleveraging. Balance sheet recessions are very different to normal recessions where interest rates cuts typically take economies out of recession. In a balance sheet recession, monetary policy is less effective. Once a key stakeholder decides to deleverage, (or is forced to do so), its demand for borrowing becomes limited (despite the lowering of interest rates) as its only goal is to pay down its liabilities. In fact, we believe these low levels of interest rates only distort economies, and place a tax on the savings industry.

2) Expect low growth for a long period of time

As is clear from the above, economies cannot grow strongly with the current scale of deleveraging in the system today.

3) Expect interest rates to remain low globally

Given points 1 and 2, interest rates around the world will remain low for an extended period of time.

4) Don't expect a great depression

We think that we will experience stagnant, anaemic growth for a long period of time, with major countries and regions tipping in and out of technical recession. We however don't expect a full-blown, great depression to play itself out.

5) Expect inflation, not deflation

While we think that either outcome is possible, we are more swayed by the inflation than deflation argument given the extraordinary printing of money by central banks around the world. The essence of our concern is that if central banks are going to print money at unprecedented rates, the more money they print, the more they dilute the value of existing money. That is essentially inflation.

Because inflation is the one big risk we all live with in investing, we think it is incumbent on us to protect you from inflation when we believe the risks are high. As such we are very heavily invested in domestic inflation-linked bonds. Most of the classic inflation hedges (gold and commodities), we feel, are expensive at the moment. As such we have to look quite carefully and be quite disciplined in our search for inflation protection. Another good example of inflation protection is commercial property, or property in general, and we believe one is starting to see some decent value coming through in continental Europe, Asia and in parts of the UK.

6) Expect emerging market economies and stock markets to outperform developed markets

This is a shift in our messaging. For some time we've been saying that we prefer developed market equities to emerging market equities. We have however recently shifted our weightings as developed markets have outperformed emerging markets this year. We also think that the challenges of excessive leverage that exist in the world's major economies are less of an issue in emerging markets.

7) While we have healthy levels of equity exposure, we are not out on a limb

Finally, while we continue to believe that equities are attractive and that you need healthy levels of exposure to this asset class, we do not think that equities are as compelling as they were during the financial crisis. The world's equity markets are up 80% plus from their financial crisis lows. For example, in February 2009, when every newspaper and commentator said that you couldn't afford to own equities, we went out on a limb and were fully invested in equities, (our Coronation Balanced Plus Fund had exposure to equities of 74% when its cap is 75%). At that time we felt it was worth the risk because we believed that stocks were already pricing in the worst case scenario. Today in Balanced Plus we are sitting at 64%, which in our minds is a below neutral position in equities. Despite all the volatility we have experienced over the past year, markets remain close to their peaks. In South Africa we are for example only 1% - 2% off the FTSE/JSE All Share peak. We haven't had much of a sell-off.

What investment opportunities have we taken advantage of in the current market environment?

The great thing about cycles is that at the cycle highs and cycle lows, incredible opportunity presents itself if you are prepared to take a long-term view in your thinking. We have identified the following three opportunities of which all our funds have taken advantage.

1) The European corporate debt market

The current European banking crisis is very similar to what the US went through three years ago. The reason for the crisis is because European banks are typically the holders of Greek, Italian, Irish and Spanish government bonds. In light of this crisis, the bonds that the European banks have issued have collapsed in value. We think that while there will be some big failures in the European banking system, there is an enormous opportunity to buy attractively priced bonds where the credit risk is low. We have for example bought European bonds issued by Investec, Old Mutual and Barclays. Investec and Old Mutual are solid businesses that we know very well. They have strong South African businesses that subsidise their international businesses, are both cash generative and we think the risk of default is low. Today you can buy these bonds at yields of between 10% and 17% p.a. in euros. Given that cash is giving you a real return of zero and government bonds are given you 2%, we regard this as an exceptional opportunity. All of our asset allocation funds have taken advantage of this opportunity in varying degrees, depending on the respective funds' risk budgets.

2) Global equities/ blue chips

We have been talking about the opportunity presented by global equities, particularly global blue chips, for at least the past 18 months. Global blue chips traded at 20 to 40 times earnings in 2000, whereas today you can buy these companies at 10 to 12 times earnings and dividend yields of between 3% and 4%.This means that even if the share price of these companies go nowhere over the next 5 years, you are still going to do better just in dividends than you would from having your money in the bond market or in the bank.

While most fund managers currently argue in favour of a full allocation to offshore assets, the end client remains sceptical due to the dismal returns these assets have delivered over the past decade. Offshore returns have in fact been very strong this past year. Had you been invested in any of Coronation's international funds, year-to-date you would have done around 10% better than by being invested in the domestic equivalents of the respective international funds. This is in spite of a natural disaster in Japan, revolution in the oil-rich parts of the world, the European crisis, and nothing short of paralysis in US politics.

The good news is that investors who have not yet increased their exposure to offshore assets still have value on their side. We believe that between 80% and 90% of the value is still to be realised. However, the opportunity will not be there forever and the great sadness would be if investors wait for the full opportunity to be realised before they decide to make the move to offshore assets.

We are not arguing for investors to take their exposure to offshore assets to excessive levels. Most studies show that an allocation of between 20% and 30% within an overall portfolio is optimal. What concerns us is that the average retired South African is sitting with exposure of between 10% and 15%, when they should in fact be reducing their exposure to the domestic stocks that are currently trading at premiums to their very best comparable peers in offshore markets (see table below).

SA stocks are highly rated

SA		GLOBAL	
Company	PE (f)	Company	PE (f)
PPC	11.3x	Lafarge	8.2x
Tiger Brands	12.7x	Unilever	13.9x
Standard Bank	9.5x	Wells Fargo	7.6x
		Barclays	4.8x
Medi Clinic	13.6x	Lifepoint Hospitals US	10.6x
Naspers	15.7x	Newscorp	11.0x
		Bskyb	13.7x
Aspen	14.1x	Teva	6.6x
Woolworths	13.5x	M & SW	9.0x
JSE	10.7x	Nyse	8.4x
Vodacom	12.1x	Vodafone	10.2x

Source: Coronation research

3) Rand hedges

The rand has been bullet proof for the last decade, but sold off sharply in the third quarter from below R/$7 to around R/$8.30 (at the time of Conversations with Coronation). This represents a downward move of 20%- 25% since the start of 2011. But because in the last 10 years every period of currency weakness was followed by a recovery, the market is not reflecting this move in its pricing of assets. This, we believe, is an asymmetrical payoff where if the market is correct and the rand goes back to the level of R/$7, you would not have lost anything as the domestic stocks were never priced for R/$8.30. If however the weakness holds, or we see an even bigger sell-off over time, we are of the view that you would have had an incredible opportunity if you had bought these assets when they were not priced for R/$8.30 to the dollar. As a result our funds are heavily invested in rand hedges such as MTN, Naspers, Bidvest, Omnia, AECI and Trencor. These are examples of stocks where there hasn't been any recognition of the weakness in the rand this year.

Our current asset allocation views:

The key message in terms of our asset allocation forecast is that we believe all asset classes will be giving you lower returns in the decade ahead (see table below), with global equities delivering a higher rand return than what we have seen in the last decade. That is why we are saying that you require a healthy exposure to these assets.

Asset class returns

	Last 10 years (ZAR)	10 year forecast
Local equity	17.4%	8 – 12%
Global equity	3.1%	12 - 15%
Local property	23.2%	8 - 10%
Local bonds	10.2%	8 – 10%
Global bonds	6.3%	5% - 9%
Cash	9.3%	7 – 9%
Inflation	5.9%	6% +

Source: Coronation Fund Managers and Deutsche as at 30 September 2011

We have spoken about equities being attractive, but not breathtakingly cheap. Our view is therefore that you need healthy levels of exposure without going out on a limb. We remain very bearish on bonds and have zero exposure to classic government bonds around the world. What we do own are inflation-linked bonds and corporate bonds where we think the credit spreads compensate for the risk. We think that domestic property yields are low. While we still expect property to outperform cash, we do not expect the very outsized returns investors have enjoyed over the last decade.