Caught in the cycle

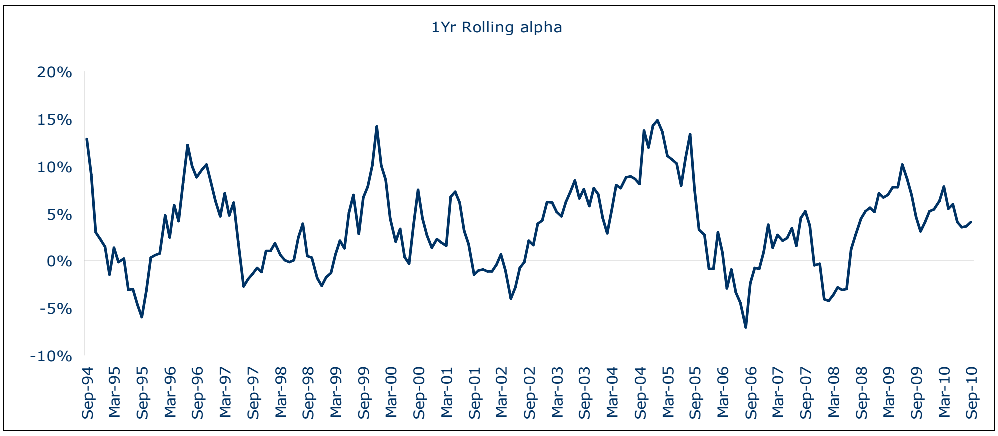
As investors we all accept that markets are driven by emotion in the short term and by fundamentals in the long term. We also buy into the other fundamental axiom of investing which is to buy low and sell high. Why is it then that we get caught in the same investment cycle time and time again?

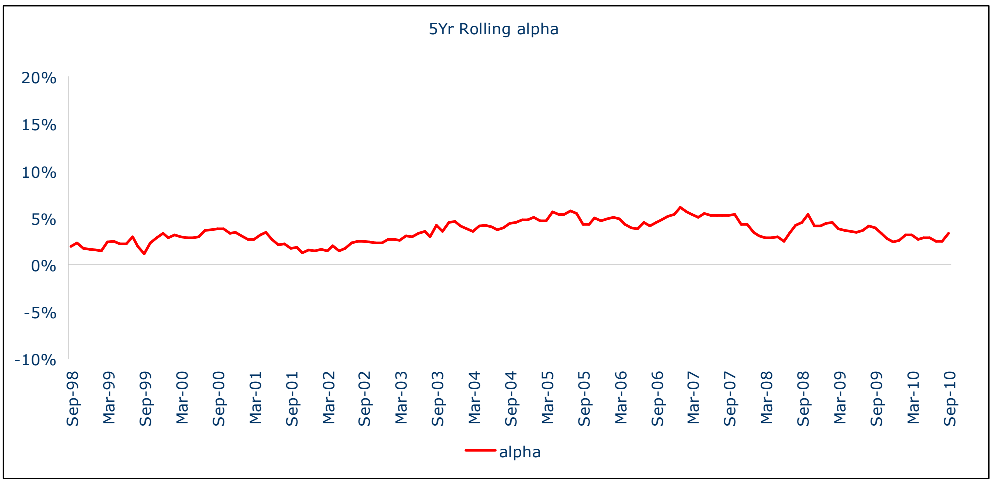
In our opinion, the answer lies in human nature. We underestimate how susceptible each one of us is to instant gratification. In the 17th century, 'Tulipmania' took hold in Holland where the first ever futures market was created around tulip bulbs. To the Dutch public, tulips became a coveted, luxury item. As prices rose, eventually to the equivalent of 26,000 euros in today's money terms for a single bulb, investors believed that the trajectory would continue. This did not happen. In one day, without warning, the market collapsed. The same scenario has played itself out in every major cycle. When prices are at an extreme low or at an extreme high, the news of the day will always be compelling, making it tempting to try and time the markets. But the market inevitably already prices in the good or the bad news of the day. The successful investor will almost always be the one who has the courage, the patience and the discipline to understand that it's a cycle. It is tough to stick to your guns when you are under-performing and you know it could be a long time before things turn. But the upside is enormous.

No short cuts to wealth creation – invest for the long term

A long-term investor with a good track record will inevitably have many challenging years. These periods of underperformance often result in the best long-term investment returns, as this is when the manager can take advantage of opportunities to buy undervalued assets from those who have capitulated on negative newsflow.

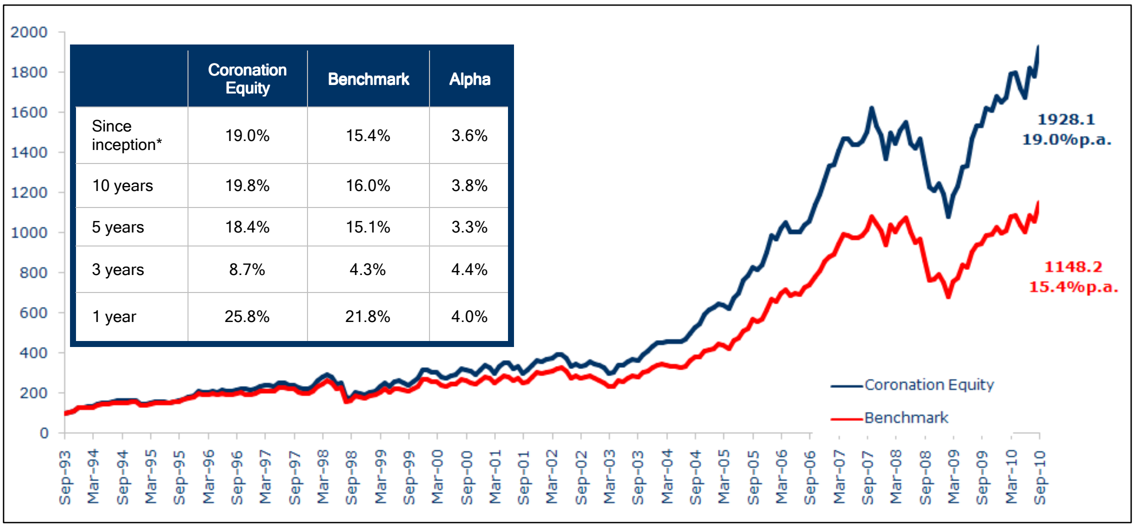
Below shows the alpha of our equity portfolios since Coronation opened for business in 1993 over rolling one and five-year periods.





Looking at periods as short as 12 months, alpha has been tremendously volatile, with many periods of substantial underperformance. However, this has always been followed by periods of outperformance as our long-term views were vindicated. Looking at the more meaningful periods of five years, alpha has been remarkably consistent, ranging between 3% - 5% p.a.

The power of compounding is staggering. Since inception of our business over 17 years ago, our performance track record has translated into 68% in value, i.e. our client portfolio is 68% higher than that of the market.



	Coronation Equity	Benchmark	Alpha
Since inception*	19.0%	15.4%	3.6%
10 years	19.8%	16.0%	3.8%
5 years	18.4%	15.1%	3.3%
3 years	8.7%	4.3%	4.4%
1 year	25.8%	21.8%	4.0%

*Incepted in 1993
Returns updated to 30 September 2010

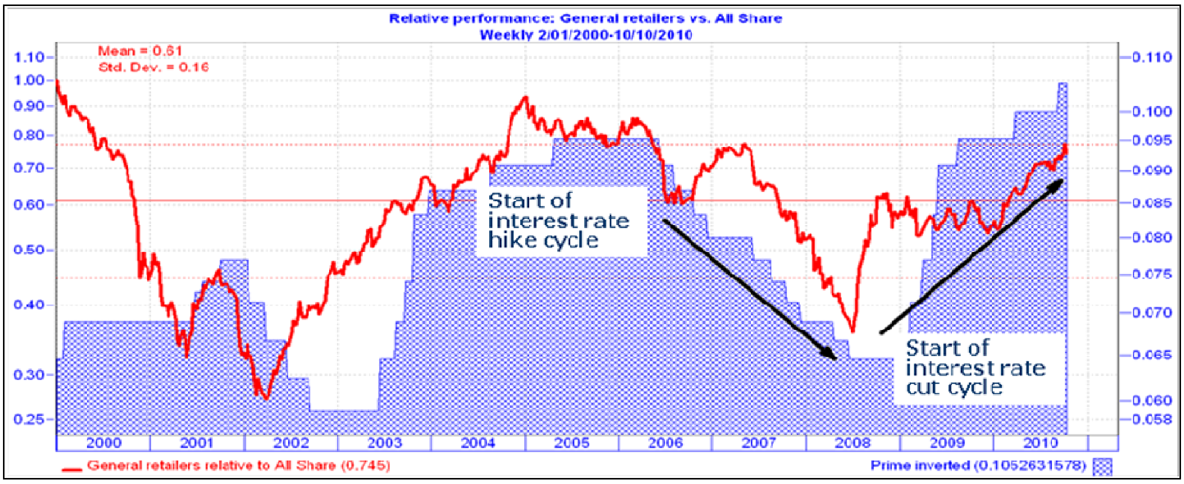
Coronation and the cycle

Our investment philosophy and process is geared at looking through the emotion of the day. While it appears that the average investor only cares about three years - last year, this year and next year, we prefer to value companies based on how we believe they will perform five to ten years out. What we care about is the next decade and this is what informs our decision making.

When we assess our own performance we look at it through the cycle. We know that we are not perfect and have, over the years, made our fair share of mistakes - but we are unwavering in our commitment to the long term. It is the easiest thing in the world to get sucked into buying at the top of the cycle (or invest with a manager when their short-term performance has been good). But the real test comes when the tide goes out. Like all managers, Coronation is going to have both good and bad years. The last two years have been very successful for us. During a time of extraordinary volatility our portfolios have all performed well. Yet, we are very concerned that investors are only investing with us because they're impressed by our short-term performance. What we prefer is to win the trust of our clients to consider us an anchor tenant (a buy and hold investment) in their portfolios. As such it is important that our clients understand our investment philosophy and what we do, rather than just buying us for our shorter-term track record.

Let's consider a practical example. South African retailers have been exceptional performers, with share prices up 3-4 times since the end of the interest rate hike cycle in June 2008. The background to this is that the pendulum has swung from fear to greed, with especially foreign investors being big buyers of local retailers. While many fund managers may currently be telling you to buy retailers, our portfolios have virtually no exposure to these shares.

Based on our assessment of mid-cycle earnings, retailers no longer offer compelling value. This can be contrasted with much higher exposure levels in 2008, when these counters presented a great buying opportunity (see chart below).

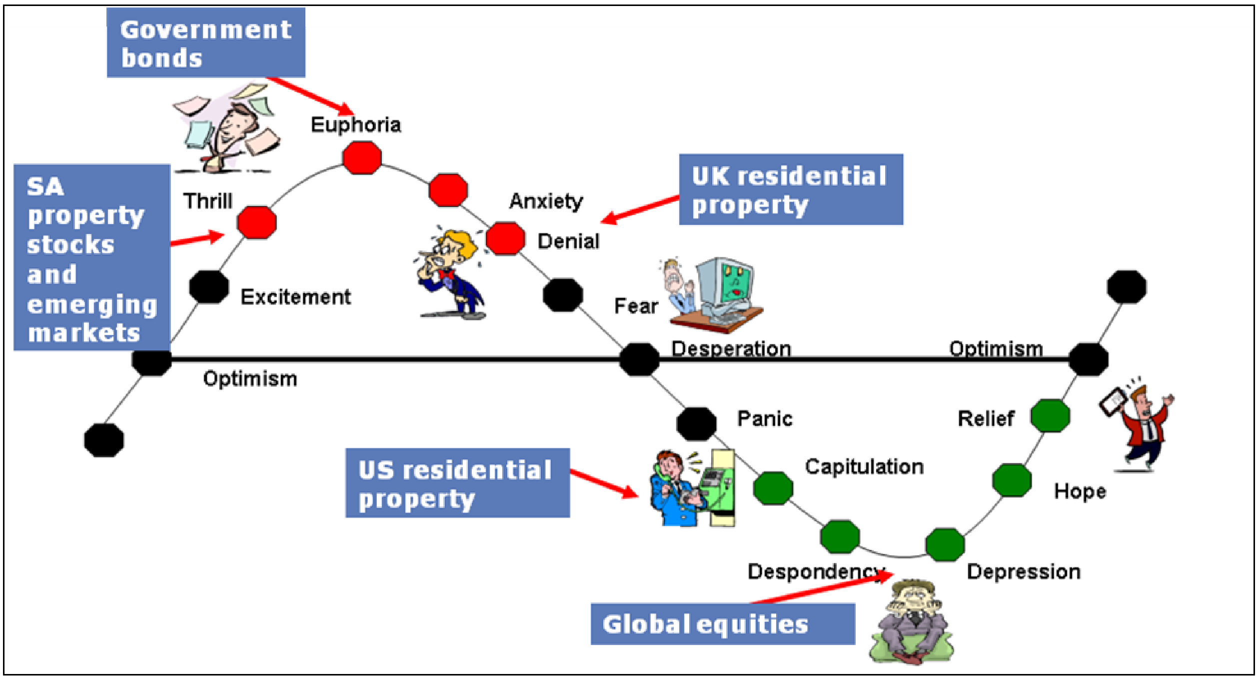


Source: I-Net Bridge

The limited exposure we currently have to retailers will in all likelihood impact our performance in the short term. If you are a market timer, you may decide to hang in a little longer. But this is not our investment philosophy. We are resolute in our belief that if you buy into retailers now, your capital will be at risk when the cycle turns.

We will not hesitate to sell when we believe an asset has become overvalued. Similarly we have the broad shoulders to be early buyers of what we believe to be the undervalued assets of the day.

Our current views



Listed property

We are becoming increasingly circumspect about listed property. The property exposure in our Coronation Balanced Fund has for example been halved from 5% a year ago, to 2.5% at present. Listed property has performed incredibly well over the past decade, returning 26.1% p.a. (in rands) to investors. At this rate of return, investors doubled their capital every three years. The sector has benefited from both a macro-economic re-rating as well as a strong commercial property cycle. We believe it is unlikely that listed property will repeat this stellar performance over the next ten years; it is more likely that this asset class will return to its traditional place in the risk/return spectrum, fitting in between bonds and equities.

Government bonds

We are very bearish on both domestic and global government bonds. We believe that global bonds in particular are trading far below their normal levels and that current yields do not compensate investors for the risks brought about by the large amounts of debt in the global system.

Domestic equities

Domestic equities have done incredibly well over the past decade as a result of the 'democracy dividend' (sound management of macro policy resulting in strong economic growth, a growing middle class, low inflation and low interest rates). This translated into a rand return of 16.9% p.a. over the past ten years from the FTSE/JSE All Share Index. We believe domestic equities are no longer cheap and that now is the time to be cutting exposure, not increasing it.

Global Equities

We remain very bullish about global equities. For almost two years we've been talking to investors about the investment case for increasing exposure to international assets. However, having enjoyed a once in a lifetime wealth-creation opportunity from being invested in domestic assets (even cash), while global equities delivered a paltry rand return of 0.9% p.a. over the past decade, many investors are still sceptical about owning global equities. Investors should be careful of looking through the rear-view mirror and extrapolating the past into perpetuity. Global equities currently offer more attractive valuations than local equities, and the rand is strong. Furthermore, their inclusion in a total portfolio provides proven diversification benefits and better matches future liabilities.