CORONATION
FUND MANAGERS

Coronation Fixed Income and Property Update

Investing in the yielding asset classes — July/August 2009

The Coronation Strategic Income Fund aims to produce a medium-term return in excess of money market funds with no negative returns over 6 months.

The Coronation Property Equity Fund is a specialist fund focusing on listed property with the aim of outperforming the SA Listed Property Index (SAPY) Index.

Inflation matters

Even at a moderate rate of inflation, the value of your money is at risk. If you plan to invest your money over the longer term, or plan to draw an income from your investment over an extended time period, your capital has to 'grow' to overcome the eroding effects of inflation. Thus, by virtue of the economic cycle - you cannot hide in so-called 'safe' investments without keeping a close eye on inflation.

Inflation peaked at 13.7% in August 2008; today it sits just outside the target range at 6.9%. At Coronation we are increasingly positive about the inflation outlook and have reasons to believe that the sticky pace of decline since the start of 2009 is unlikely to continue. According to our current estimate, inflation is likely to move back within target range by January/February next year. We do, however, believe that the pace of decline, going forward, is likely to slow down.

This more positive inflation outlook is largely driven by three factors - namely food prices, producer price inflation and the rand.

Firstly, maize and wheat prices, which are a reasonable proxy for what is happening to food prices, are running in excess of 30% down on a year-on-year basis. While this has not yet reached the consumer in terms of lower retail food prices, it has already fed through to falling agricultural producer inflation and slowing manufacturing food inflation. Given the relatively large weighting of food prices in the overall CPI, the impact of this is likely to make a material difference.

The second positive contributor is producer price inflation (PPI). PPI tends to lead CPI with approximately a four-month lag, and the gap between these two measures, currently at 11%, is not sustainable. If the long-term relationship holds, PPI is likely to exert downward pressure on CPI in the near future.

Thirdly, a key reason for the 'sticky' inflation experienced in the latter part of 2008 and early part of this year was the weakness in the rand last year. It has however appreciated some 24% by mid-August from its lows in early March 2009, and this is likely to have a significant dampening effect on inflation in the second half of the year - provided it holds these levels.

A further encouraging signal is global inflation. CPI in the US has continued to navigate lower since peaking in July last year. Lower global inflation should also provide support for the direction of local inflation.

Where we see short-term lending rates

In addition to having a major influence on investing in fixed income assets, inflation also drives monetary policy. The repo rate, which is the most important indicator of short-term interest rates, peaked at 12% a year ago. This has been cut substantially since the start of the easing cycle and is now at 7%.

Considering the poor health of the domestic economy reflected in the steady drop in year-on-year manufacturing production and real retail sales, we don't believe that short rates will rise anytime soon. If anything, these rates are more likely to fall further, which poses a significant risk to money market investors who have already seen the yield on their investments drop to levels that cannot keep pace with inflation – currently yielding in the region of 7.5%.

Our current fixed income view and portfolio positioning

At Coronation our near-term outlook for bonds remains murky. While we are very positive about inflation and the short rates cycle we do have concerns about global bond yields - pressure from the massive amount of issuance to fund yawning budget deficits is likely to weigh the market down for a while. As a result, we are neutral on interest rates from a directional point of view.

In terms of curve positioning, we are overweight in the short/mid area of the yield curve (3 to 5 year duration). We expect the curve to normalise even more as short rates may decline further. However, funding pressures could weigh heavily on the long end.

Our portfolios are overweight in good quality corporate bonds, including parastatals, which we have picked up at very attractive spreads over government bonds.

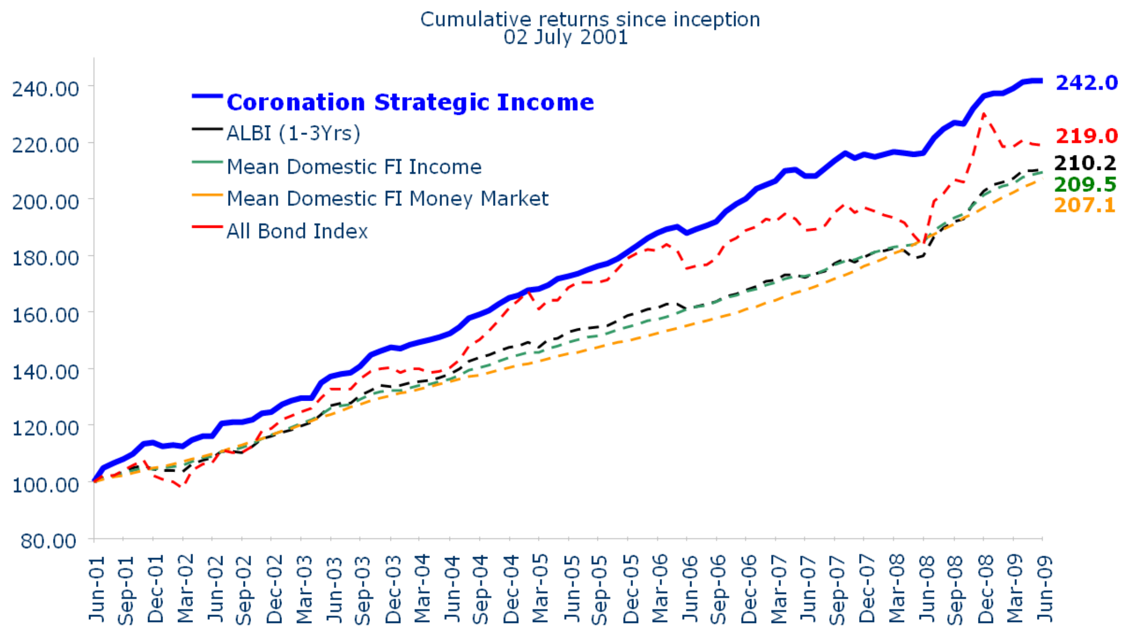
We remain positive on inflation-linkers. This fixed income instrument presented a fantastic opportunity and we participated in a number of recent auctions set at very attractive real yields.

Coronation Strategic Income Fund

Cash has been a phenomenal performer over the past two years. However, we believe it's unlikely to continue this trend. We can, with a high degree of certainty, conclude that money market funds are not a suitable solution for investors requiring income over the medium to longer term.

The Strategic Income Fund is an asset allocation fund which invests across different fixed income assets. Since inception eight years ago it has returned 11.7% per annum. However, in order to achieve returns in excess of cash, an element of risky assets is required in the portfolio. As such, the fund is currently mandated to hold up to 10% in listed property and up to 10% in preference shares, but will not hold ordinary shares.

While short-term performance has recently been in line with cash, over the long term the fund has outperformed all relevant benchmarks since inception. In addition, the positive outlook of stable and potentially declining short rates should provide further support for performance going forward.



Source: Morningstar as at 30 June 2009

Changes to the fund

Coronation will reduce the management fee applicable to the Coronation Strategic Income Fund with effect from 1 October 2009 in recognition of the recent decline in interest rates and our view that rates may remain at lower than historically experienced levels for an extended period of time. We've also decided to expand the fund's investment universe and in turn change the benchmark to 110% of the STeFI 3-month Index return. Please refer to the Investor Update section on our website for further information.

The risk of not taking enough risk

While Strategic Income is a significantly more efficient investment option than a money market fund for investors seeking both income and growth, it is not ideal for those investors who wish to draw a higher level of income from a single portfolio over periods in excess of five years. We believe the appropriate approach for securing a long-term real income without significantly eroding capital is to introduce well considered exposure to risky assets, such as shares and foreign investments within a robust risk management framework.

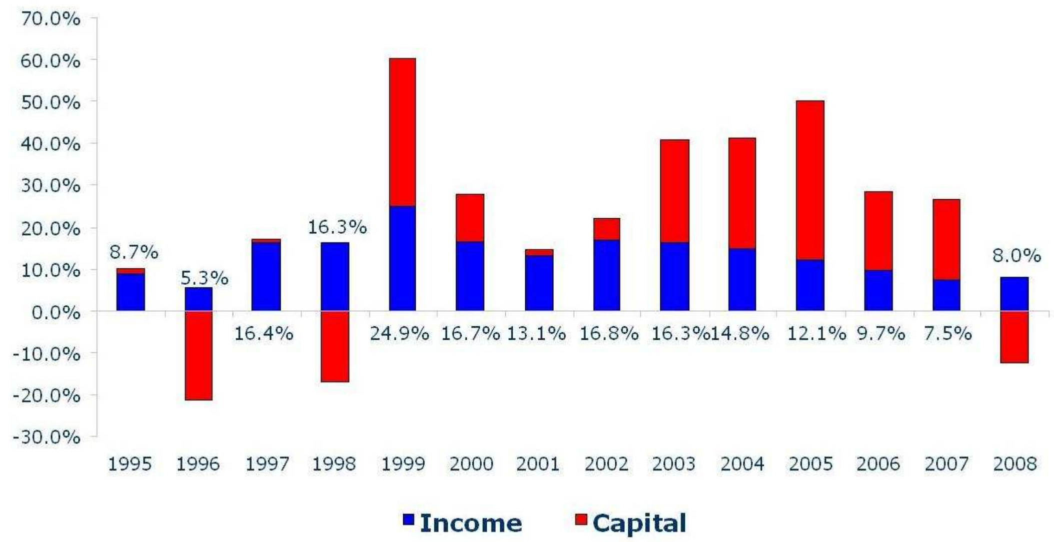
Both the Coronation Capital Plus and Balanced Defensive funds are managed to support moderate to higher real income targets, while controlling the risk of capital loss in the short term.

The Coronation Capital Plus Fund has delivered real returns of 9% p.a. since launch in 2001 and has the ability to invest up to 60% of the portfolio in risky assets. The Coronation Balanced Defensive Fund was launched in 2007 in recognition of the need to provide a fund with a more conservative risk budget and therefore lower expected volatility when compared to Capital Plus. Balanced Defensive holds between 60% and 80% in fixed income assets with the balance (20% - 40%) in risky assets, i.e. domestic equities, international equities and property. While too early to fully evaluate the fund's track record, we are very pleased with its exceptionally low downside deviation of 0.82% through the '100-year flood' of 2008.

For more information, please refer to the 'Investing for income and growth' article in our July issue of *Corospondent* (also available on our website).

Why property?

Investors have traditionally invested in listed property for the stability of its underlying income stream. However over the past five years the focus has shifted to capital growth. The phenomenal capital returns achieved by investing in property over this period were not without a substantial increase in risk - as such listed property started to behave less like bonds and more like equities in terms of volatility.



Coronation Property Equity Fund

The Coronation Property Equity Fund provides investors with exposure to the listed property market. It uses bottom-up stock selection and Liberty International as a risk diversifier and is ideally suited for use as a building block within a total portfolio.

Given the vast increase in property unit trusts and differing mandates, the fund's benchmark changed from the domestic real estate mean to the FTSE/JSE SA Listed Property Index (SAPY) in May 2009. This we believe is a more appropriate indicator of what the Coronation Property Equity Fund sets out to do.

The fund has outperformed its new benchmark in the most recent quarter (June 2009), and over one and three years. Outperformance for the quarter can be attributed to the relative positioning in stocks like Fountainhead Property Trust, Acucap Properties, Growthpoint Properties and Resilient Property Income Fund versus those in the broader peer group and the SAPY Index.

Fund positioning

Property stocks have remained very volatile in 2009 and may come under some pressure as uncertainty remains around interest rates. We have high conviction in listed property companies with a retail bias as is evident in our top five holdings: Growthpoint, Hyprop, Acucap , Fountainhead and Resilient. The underlying theme of these holdings is that they all specialise in super regional and regional retail properties.

Why retail properties given the current economic environment and slowdown in consumer spending?

In terms of rental growth over the past 10 years, retail properties have been more stable than industrial and office properties. In addition, while all three property sectors were not spared over the 12 months to end March 2009, our conviction in the defensiveness of super regional retail properties was vindicated, being the only grouping to record positive growth in trading densities (revenue per square metre).

Probably the biggest threat to the retail property sector is the increase in vacancies as the amount of space completed continues to grow. We expect the overall retail vacancy rate to rise in 2009 as the sector continues to weaken. However, we believe the impact on super regional and regional retail properties is likely to be limited, with marginal retail properties being worst hit.

Another argument to ease concerns about vacancies is to look at the historic non-residential building activity as a percentage to GDP. Over the past four decades, we have seen a gradual decrease in building activity in this sector and only since 2004 have we seen activity return to its historic average. One could therefore argue that the amount of space completed is merely catching up with historic under investment.

Listed property outlook

Property cycles normally last between 7 and 8 years and given that the previous cycle ended in 2007, we're probably two years into the current downcycle. The cycle may last another 3 to 4 years before we see a pick-up, but it may be shorter due to a positive impact on the economy due to the FIFA Soccer World Cup and expected positive GDP growth in 2010 and 2011.

While we are definitely seeing an unwinding of risk in the local listed property environment, specifically in those companies with exposure to marginal developments, we believe that the current downcycle will not last as long as the historical average.

Why invest in a diversified portfolio of listed property?

The key considerations that we take into account when evaluating property development opportunities are: transparency; diversification and development rationale. These may also prove a useful guide if you are looking to enter residential development as a second or third home buyer, as a property syndication or are buying a commercial property.

- Transparency

When deciding to buy a property one has to ensure that the management team is transparent, that they are trustworthy and have a good track record. Transparency is also paramount to the property's income stream; you need to know the source of any form of income. Thirdly, transparency of disclosure means that your questions are answered with the appropriate amount of information made available.

- Diversification

As with any portfolio, diversification in assets helps spread the risk of monetary loss, while diversification of tenants helps spread the risk of income loss. And diversification of funding (i.e. access to more than one bank or investor) ensures that your portfolio is less risky as various sources of capital are available.

- Development rationale

One should not invest in a property unless there's a very good reason why the property has been developed and that there is potential for value to be unlocked.

In our view, listed property is the route to accessing the property market as it is easier to ensure that these considerations are met, even for investors with limited capital.

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