Coronation Capital Plus and Absolute Funds

Balancing short-term capital preservation and long-term, inflation-beating returns

Our investment approach emphasises bottom-up stock selection and strong asset allocation views - each of our funds are managed to achieve a specific level of risk and return.

Whilst no explicit guarantees can be offered with regard to capital preservation over any given period, the aim is not to lose money over specified periods.

We are resolutely focused on the long-term, and our stock selection within the portfolios has a distinct valuation bias, which ideally suits the 'capital preservation' strategy of our absolute funds.

Recent market performance

The equity sell-off of 2008 was severe and had a significant impact on medium-term market returns. Over three years, local shares have returned only 2.1% p.a. and global shares an annualised -0.4%. These below-average returns are attributable to a more than 30% decline in local and global markets over the past 12 months. As a result, only cash (10.6% p.a.) and domestic listed property (9.6% p.a.) outperformed inflation (8.5% p.a.) over the past 3 years. Over the longer term, local equity performance remains very attractive, with annualised real returns of 11.5% and 7.8% over the five and ten year periods.

Against this backdrop investors have understandably become extremely cautious about where to put their money, with capital preservation being their first priority. But how does one avoid capital losses in the short term while still retaining the ability to earn reasonable real returns over the long term? - Funds that offer inflation-beating returns at low levels of volatility.

Recent fund performance and positioning

The Coronation Capital Plus and Absolute funds seek to balance short-term capital preservation and dependable inflation-beating returns over the long term. Our investment approach emphasises bottom-up stock selection and strong asset allocation views, and each fund is managed to achieve a specific level of risk and return.

While the long-only constraint that applies to unit trusts means that we can't expect to make money in falling markets, we have protected capital very well. Long-term risk-adjusted returns remain very attractive, and we are confident about achieving the funds' return objectives over the medium term based on the attractive valuations we have identified.

Capital Plus, which is managed to limit the downside in tough conditions, delivered on its investment objective and preserved capital through the acute market correction of 2008, with a return of 3.3% for the most recent 12-month period as at 25 May 2009. Over three years, its annual return of 9.5% is ahead of inflation and in line with cash - a very good outcome given the poor returns produced by risky assets over this period. Over five years, the fund produced an annual return of 15.7%, compared to inflation of 6.6%.

Absolute, which shares the Capital Plus philosophy coupled with a more aggressive mandate, lost 6.5% over the past year as at 25 May 2009. Over five years, however, the fund produced 17.3% p.a. (1.6% p.a. ahead of Capital Plus). Because of its higher return target and bigger risk budget it is better suited to capture the upside in positive market conditions, but at the expense of bigger draw-downs in tough markets.

Capital Plus Fund

During the market sell-off (June 2008 to March 2009) the fund produced a positive return of 0.7%, compared to a 34% loss recorded by the JSE and the average medium-equity prudential fund's loss of 15.6%. Since inception, Capital Plus has produced a return at the high-end when compared to the average pension fund portfolio and importantly achieved this with significantly less risk.

The equities held in Capital Plus declined by only 2% over the past year, compared to the benchmark's loss of 26%. Over five years, the fund's equity holdings outperformed the market significantly, returning 25% p.a. compared to the market's 19% p.a. The real estate, bond and foreign holdings in the portfolio have also performed well relative to benchmark over both the one and five-year periods.

We are currently below the 50% maximum domestic equity weighting of the portfolio at 37%. International assets are at the maximum 20% which is equally weighted between shares and cash. The high cash holding of 24% provides the flexibility to make use of opportunities as they present themselves. While we believe that equity markets present a once in a lifetime buying opportunity, with attractive valuations supporting a high probability of producing inflation-beating returns over the next 3 to 5 years, near-term economic uncertainty will persist and the cost of hedging remains high. Our current equity exposure is, however, high enough to benefit from the recovery.

Our equity positioning remains conservative, with the bulk of exposure to defensive shares where we have more certainty about future earnings streams. These more recession-proof shares represent 22% of the fund, while more cyclical shares represent 15%.

The rationale for the more risky equity exposure relates to:

- Stronger valuation support than we would normally require
  (e.g. Remgro with a diversified portfolio trading at a discount of 20% to depressed market prices and Richemont that are valued at depressed near-term earnings rather than higher normalised earnings)

- Unique factors making the business model of the company superior, available at a reasonable price
  (e.g. Truworths, focused on the fashion-conscious 18-30 year old niche market and the benefit of being able to identify the winning seasonal trends in London, Paris and New York before bringing to SA six months later, and Mr. Price as a cash-based value retailer)

- The diversification benefits in tough times provided by a small exposure to gold

Absolute Fund

This fund aims to perform ahead of inflation by at least 6% over 3 - 5 years, making short-term capital preservation less important than achieving significant real returns over the medium term. Absolute holds primarily the same shares as Capital Plus but in higher concentrations. It currently has 60% exposure to local equities, 20% in global equities, a small position in local listed property and 17% in cash. Exposure to specific shares are similar to Capital Plus, with 36% of the fund invested in more defensive companies and 25% in more cyclical businesses.

Market outlook

Global risky assets in general, including equity, property and corporate bonds remain attractively priced. Offshore equities in particular are undervalued at present. However, given the remaining economic and market uncertainties, our focus remains on the higher quality and more defensive shares in our absolute return funds. We believe that inflation-linked bonds, listed preference shares and domestic listed property are currently more attractive than domestic long-bonds.

Equity markets

The speed and extent of the recent bear market is bigger than any other of the past 50 years, exceeding losses in the oil crisis of the 1970s and the tech wreck of 2000 - 2001. Only the Great Depression of the 1930s caused bigger losses. Over the past two years most global markets declined between 60% and 80% from peak to trough (in dollar terms). Even after recovering by between 35% and 80% this year, the major markets are still only valued between 40% and 60% of peak, leading to negative dollar returns from all markets except China over the past three years.

We, however, believe that it is not probable that the current bear will be as severe as the 1930s for the following reasons:

- The valuation level at which the crash in 1929 started was around 25% - 30% higher than the market level at peak in 2007

- Economic conditions appear less dire than in the 1930s, when US unemployment peaked at 25% (currently at 8%) and US GDP declined by 25% (3%-5% decline expected at present)

- Governments and monetary policy makers have responded much more aggressively to prevent the economic crisis from spiraling out of control

- Large scale urbanisation in emerging markets such as China and Brazil will provide support that was not available in the 1930s

- Globalisation makes multi-nationals such as Coca-Cola, Microsoft and SABMiller more resilient as they have access to bigger markets and are less reliant on the health of one specific economy

Equities remain the asset class with the highest probability of providing inflation-beating returns over the long term, with average real returns between 6% and 9% having been produced by equity markets around the world over the past 109 years. Quality companies are currently trading at dividend yields of between 5% and 6% and we believe it likely that the return on equities will be above the long-run average over the next decade.

Further reasons as to why return prospects from the equity market are attractive:

- Equity returns are typically above average in the ten years after market bottoms

- The world P:E ratio is currently around 10-12 compared to its average of 17 since 1970

- The Shiller P:E, based on 10-year average earnings to remove the impact of economic cyclicality, is currently at 12 compared to an average of 16 since 1880

Many investors may believe that it is sensible to wait for confirmation of better economic conditions and signs of more stable markets before reintroducing risky assets to their portfolios. We think that this timing-based strategy is dangerous. A recent study by Legg Mason confirms that the bulk of the returns happen in the first nine months after the low point in bear markets. By the time you know things have stabilised, everyone else does too - meaning that better conditions will already be reflected in higher share prices.

Bonds

We continue to have a negative view on bonds, due to inflation risk and the significant increase in issuance that is expected. We are therefore significantly underweight bonds and prefer short-duration and variable rate instruments.

Government's funding position has deteriorated due to the worsening economic outlook and a commitment to increased infrastructure spending. In the recent past, Government was in a net buyback situation, with debt maturing faster than being issued. This, however, changed during 2008. National Treasury expects net issuance to be between 5% and 8% of GDP in the next three years. The state-owned enterprises,

including Acsa, Eskom and the Roads Agency, are also expected to increase issuance. In addition, inflation has proved to be stickier than most economists expected, with negative surprises in most months this year. We currently expect inflation to only return to the upper end of the target range (3%-6%) in 2010.
We have however seen opportunities in corporate and inflation-linked bonds. The R189 government inflation-linker maturing in 2013 historically traded at a real yield between 2.2% and 2.5%, but moved out to 3.5% earlier this year. At the same time, corporate spreads increased as a result of risk-aversion, which allowed us to initiate placings with highly rated banks at real yields of between 5.75% and 8%, locked-in for the next five years. At the time of writing, this opportunity, has already closed out, with the R189 returning to its historical real yield of 2.2%.

Domestic Listed Property

While we still see opportunity in this asset class, we have become more cautious. The weighted yields of the real estate shares held in the portfolio are around 10% compared to long bonds yielding 8.0% to 8.5%. In addition, we expect to realise income growth of between 7% and 8% over the next three years, resulting in an expected annualised return of 19% - 20% from quality property assets. The outlook for commercial property, however, is subject to events in the economy and risks have clearly increased. We therefore focus on high quality and more defensive property counters, giving exposure to super-regional shopping malls, A-grade offices with long leases or secured income streams through investing in instruments with the first right to any income produced.

A few examples of where we see value

SABMiller [3rd biggest holding in Capital Plus and Absolute funds]

SABMiller is a global branded consumer group that is currently the 2nd largest brewer in the world. Profits are generated from all corners of the globe, with 39% from Africa, 25% from Latin America, 24% from Europe and 12% from North America. The company employs a consistent business system, adapted to local conditions across multiple continents, countries and currencies.

Beer is a good business, as it sells desirable branded products that can be premium priced. Earnings are defensive as consumers continue to drink beer through good times and bad. It is also a good cash-flow generator. SABMiller has the most diversified global portfolio of all the beer majors, with a combination of markets producing steady cash flows and providing interesting growth opportunities. We rate management highly for their acquisition record, turnaround skills and world-class operational ability. The company produced annual free cash flow of $2bn, placing them in a very competitive position to benefit from further consolidation in the industry as most of the other majors are still struggling to digest significant recent acquisitions. SABMiller have exposure to concentrated markets (e.g. Columbia or Botswana) where profit margins are higher than in more fragmented markets. We expect the company to grow earnings by 12% p.a. in dollar terms over the next five years. While the company is not cheap relative to its direct competitors, the global beer sector is currently trading at a P:E of 12 - 13, which in our opinion is lower than is justified based on long-term prospects. In the next five years, we expect that shareholders in SABMiller will benefit from a re-rating of this multiple to around 16 - 17.

Mondi [Small holding in Capital Plus and Absolute funds]

Mondi is a primarily European packaging and paper company. The fundamentals of the paper industry are poor, but we invested in the business primarily because of its attractive current valuation. Mondi is stronger in packaging and office paper than in coated fine paper and therefore sustainability less affected by substitution of magazines and newspapers by the Internet. Mondi has a low-cost advantage compared to its competitors as a result of the location of its paper mills in emerging markets, which allows them to price more competitively while at the same time achieving higher margins. It is significant that the company has been able to remain profitable, while most competitors recorded losses in a dire industry. This means that the company is likely to be a beneficiary from expected industry consolidation. However, the share is unloved by the market because of short-term concerns linked to the economy and sentiment. It has performed very poorly since unbundling from Anglo American, falling from a share price of R70 to a current price of between R25 and R30. The business is valued at a 10 P:E on what we believe to be trough earnings, and a 6 P:E on normalised earnings. A further discount of more than 20% is available by buying the share in London rather than Johannesburg.

Spar [Top 10 holding in Capital Plus and Absolute funds]

Food retailer Spar is a superior business, with a return on equity in excess of 50% and the ability to convert all its earnings into free cash flow. It has scale benefits through a well-established head office and distribution centre infrastructure that can be scaled across more stores. Over the past twelve years, margins were very stable around 3.6%, with significant cost benefits passed through to consumers as its scale increased. The company follows a franchise model, reducing the need for capital and allowing the group to benefit from its partnership with motivated owner-managers. Spar has significant brand value, with a 45-year history and very high loyalty from its franchisees. They have a strong presence in the rural market, where competition is less and the impact of the global economic cycle is more muted. They are also expanding in the liquor and construction markets through their Tops and Buildit brands. Over the past 8 years Spar's market share increased from 16.6% to 22.9% at the expense of Pick 'n Pay and Shoprite. While the company produced superior earnings performance relative to the market since 2007, it underperformed in terms of share price change. With a 5.5% forward dividend yield, we believe that Spar 'remains good for you'.