ISSUE 01
01

COROLAB

Your guide to investment ideas

CORONATION STRATEGIC INCOME

A compelling cash alternative

April 2011

CORONATION
FUND MANAGERS

MARKET OUTLOOK

Early in 2010 we warned that money market rates were likely to remain low for an extended period of time. This was premised on the likelihood that policy makers would err on the side of caution by keeping interest rates lower for longer despite the tentative signs of economic recovery.

This is exactly how subsequent events unfolded: the Monetary Policy Committee in November cut the repo rate to levels last seen 30 years ago, and has kept it unchanged at 5.5% since then. Given that inflationary pressures are building in the underlying economy it appears likely that the next move is up, either later this year or early in 2012.

While the expectation of rising rates may seem like good news to conservative investors investing for immediate income, it becomes more difficult to outperform money market rates as we will explain in this issue. Aiming to enhance cash returns does remain an important objective however as inflation (CPI) is expected to either reach or breach the upper limit of the 3% – 6% target range later this year. This means that the real return available from cash is likely to remain below average, or even become negative (see Figure 1).

Despite a more challenging environment, we hold firm that an appropriately managed income fund such as the Coronation Strategic Income Fund remains the intelligent investor's alternative to a money market fund.

FIGURE 1 THE REAL RETURN ON CASH IS LIKELY TO REMAIN BELOW AVERAGE

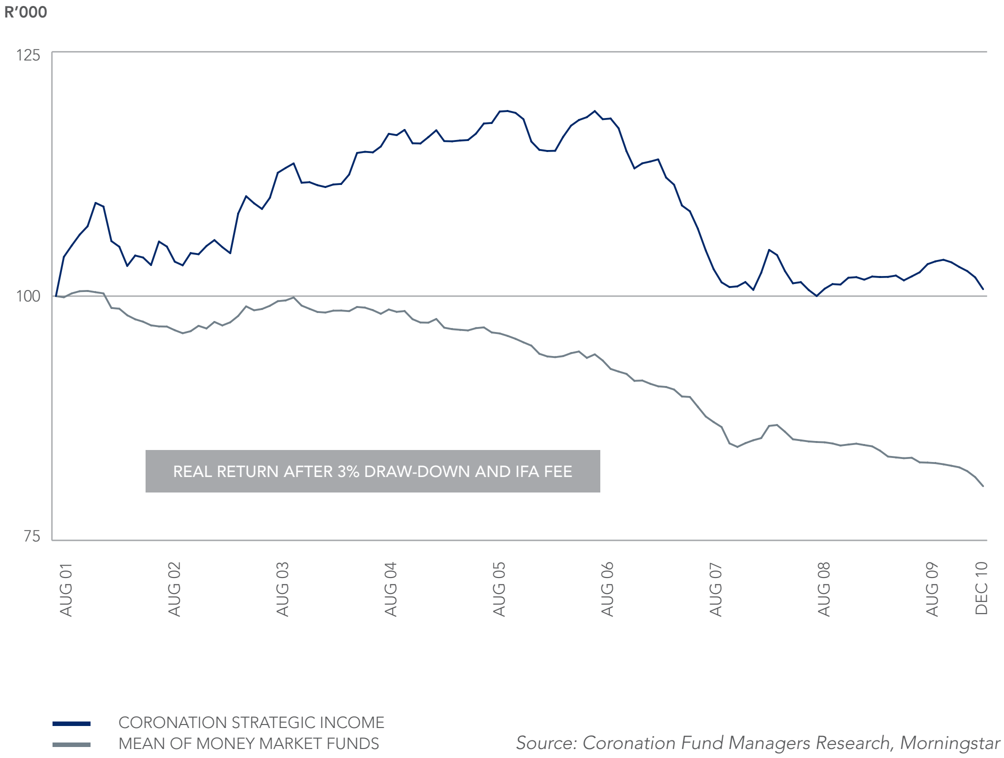
Source: I-Net Bridge

LONG-TERM IMPLICATIONS

Money market funds are designed for short investment periods and are rarely appropriate for terms exceeding 2–3 years. These funds cannot keep pace with even moderate inflation and if an investor requires any kind of regular income (draw-down) or pay any tax, money market funds should be used with caution.

From Figure 2, it is clear that money market funds cannot protect an investor's capital over the long term, even at a low draw-down rate of 3%. Returns on money market investments remain low and inflation pressures are building. Thus we believe investors should consider an actively managed fixed interest fund that has the ability to outperform cash over the long term, and aims to protect investor capital by including higher return assets – without taking on undue capital risk.

FIGURE 2 MONEY MARKET FUNDS CANNOT HANDLE DRAW-DOWNS

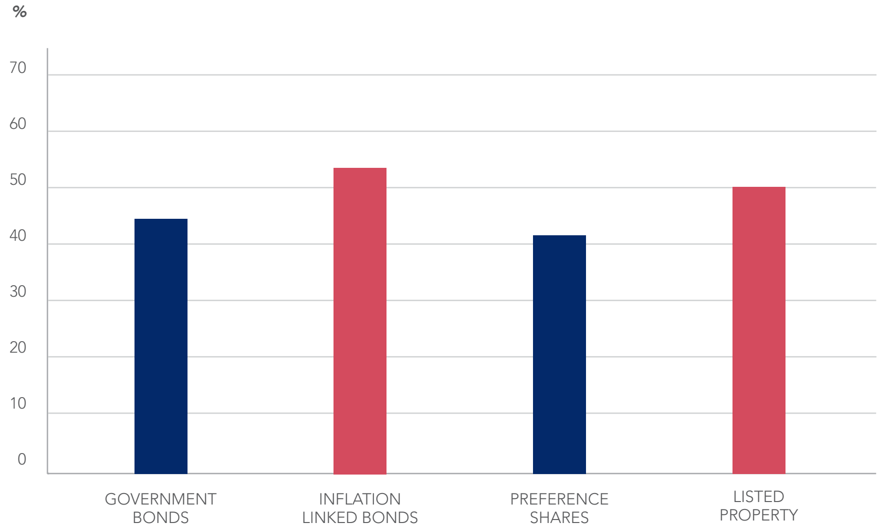


Source: Coronation Fund Managers Research, Morningstar

THE NEED FOR INVESTING IN HIGHER EXPECTED RETURN ASSETS

Inflation can have a dampening effect on investment returns and cut deeply into purchasing power over long periods. In order to outperform inflation investors need exposure to assets with a higher expected return. Figure 3 illustrates how these assets (e.g. government bonds, listed property, etc.) have from time to time generated higher returns than cash. In Strategic Income, we increase exposure to these assets when we expect the probability of outperformance to be high.

FIGURE 3 PERCENTAGE OF MONTHS ASSET CLASSES OUTPERFORMED CASH*



** Since inception of Strategic Income in 2001*
Source: Coronation Fund Managers Research, I-Net Bridge

WHY THESE ASSET CLASSES OUTPERFORM CASH ONLY SOME OF THE TIME

Despite having higher expected rates of return than cash, all the asset classes (mentioned above) are subject to higher levels of risk than cash. A significant source of risk to asset classes that primarily earn their investment return through yield is interest rate risk. The textbook definition of this concept is the possibility that the value of a bond (or other debt instrument) will decrease due to rising interest rates. Interest rate risk exists because most bonds pay a fixed rate of interest over a defined period. This rate is set according to prevailing market rates at the time of issue. When market interest rates change after this fixed rate has been set, the bond's value in the secondary market will adjust to reflect this change.

When market rates fall, the relatively higher fixed rate of the bond already in issue will become desirable, meaning that its market price will increase. The owner of the bond is now able to sell it for more than the initial value lent to the issuer of the bond. However, if rates rise, the now below-market fixed rate of the bond will be less attractive, causing the bond's value to fall. The longer the period that you are locked in to earning a below-market rate, the bigger the decline in value of the bond in the secondary market. >

WHY THESE ASSET CLASSES OUTPERFORM CASH ONLY SOME OF THE TIME

This explains why it is more difficult to outperform cash in a rising interest rate environment: the asset classes that are most able to produce better returns than cash over the long term, actually suffer capital losses as rates rise, causing you to underperform cash in the short term.

One of the reasons why money market funds are the safest unit trust portfolios is a very low level of interest rate risk: the average time to maturity for the investments held in a money market fund is only 90 days, compared to around 6 years for the typical bond fund. Strategic Income will typically invest in bonds which will repay capital invested within 6 months to 3 years.

Fixed interest markets are highly efficient, because market participants attempt to discern the path of rates over the next 6 to 12 months. At the time of writing, the market assigned a 100% probability that rates would have increased by 0.5% in one year's time.

ALTERNATIVE SOURCES OF RETURN

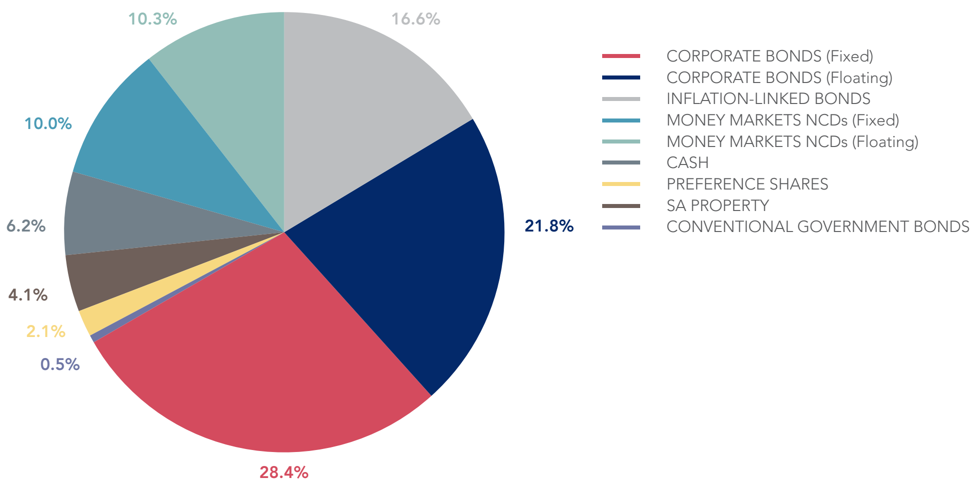
Given the change in enviroment, what will Strategic Income do differently in order to generate return?

Inflation-linked bonds

Figure 4 shows that Strategic Income currently has a substantial holding of almost 17% in inflation-linked bonds (ILBs). We have been increasing our holding during a time of falling inflation. While some have questioned the timing of our purchases, the simple answer is that these bonds are illiquid – once inflation is on the rise it is often too late to find any available in the market.

The fundamental benefit of holding these bonds is that they are less correlated to other asset classes and therefore reduce overall volatility within a portfolio. During inflation upswings, ILBs offer both inflation protection and an uplift in yield, making them a great diversifier in a long-term, multi-asset class portfolio. >

FIGURE 4 PORTFOLIO COMPOSITION AS AT 31 MARCH 2011



ALTERNATIVE SOURCES OF RETURN

Floating-rate notes

While most bonds have fixed interest rates that are set on first issue, a floating rate note (FRN) has a variable interest rate. This means that its interest rate will go up and down ('float') to reflect changes in market rates. As 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 money market rates, it makes sense to favour these instruments when interest rates start to rise. As at the end of March 2011, Strategic Income held 33% in FRNs.

Corporate credit

The corporate credit market saw a significant compression in yield as the financial shape of its issuers improved, contributing positively to Strategic Income's return. In an improving economy – a rising rate environment – these spreads may compress even further. Hence, we maintain significant exposure to good quality corporate bonds (29% of fund), trading at what we believe to be attractive spreads over government bonds of which we hold very little (0.5% of fund).

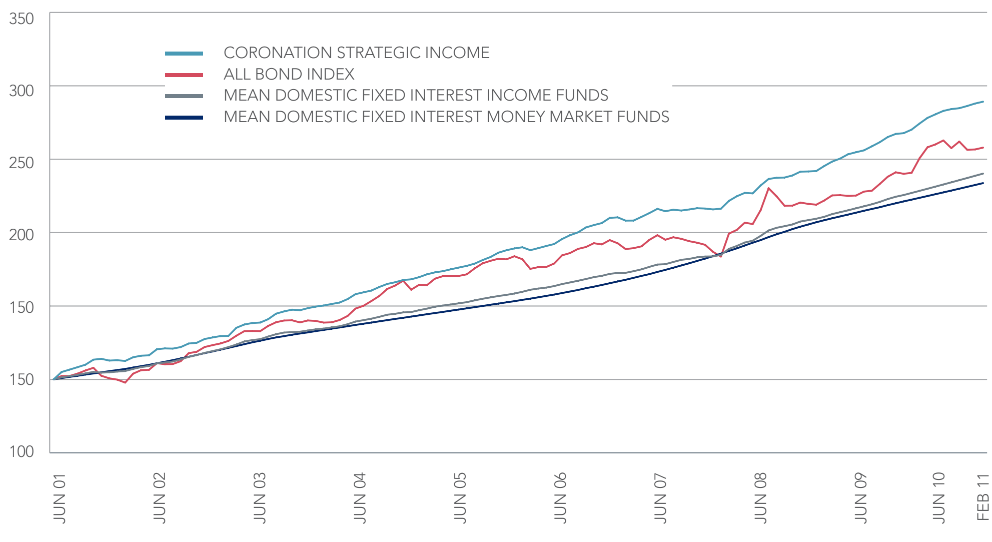
HAS THE STRATEGY DELIVERED?

Figure 5 illustrates the superior long-term performance of Strategic Income. This can be attributed to our skill in instrument selection and asset allocation within the fixed interest universe.

During 2010, the fund was appropriately positioned to benefit from the gains available from the declining interest rate environment and delivered an exceptional return of 11.2%, outperforming cash by 4%.

However, we are now close to or at the bottom of the interest rate cycle, meaning that in the near term we expect a return much closer to cash interest rates.

FIGURE 5 CUMULATIVE RETURNS SINCE INCEPTION TO 31 MARCH 2011



Source: Morningstar

CORONATION STRATEGIC INCOME

Coronation Strategic Income is a proven cash-outperformer over the longer term. Since inception to end December 2010 the fund beat cash (as measured by the Alexander Forbes 3-month (STeFI) Index) by 2.4% per annum (see Figure 6.1).

The fund has a flexible mandate with no prescribed maturity limits for the securities in which it invests. It also has a flexible duration policy and seeks to protect capital in times of bond market weakness. Its asset allocation is defensive, taking exposure to other growth assets to a maximum of 25%. These growth assets include listed property (maximum exposure of 10%), preference shares (maximum exposure of 10%) as well as foreign yielding assets (maximum exposure of 10%), but excludes ordinary shares.

Strategic Income aims to provide a higher level of income than a money market or pure income fund and moderate capital growth. The fund has historically preserved the long-term purchasing power of investors' capital at a draw-down level of 3% (refer to Figure 2). Investors requiring a level of income of 5% and more should however consider funds with larger risk budgets as these include exposure to equities.

FIGURE 6.1 STRATEGIC INCOME PERFORMANCE VERSUS CASH

	STRATEGIC INCOME	CASH (STeFI 3m)
SINCE INCEPTION RETURN (CUMULATIVE)	189.23%	133.70%
SINCE INCEPTION RETURN (ANNUALISED)	11.51%	9.10%
2010	11.23%	6.58%
2009	8.24%	8.64%
2008	9.72%	11.71%
2007	7.73%	9.41%
2006	10.40%	7.45%
2005	9.85%	7.06%
2004	11.88%	7.75%
2003	18.09%	12.27%
2002	9.58%	11.77%
2001 (6 MONTHS)	13.98%	4.78%

INVESTOR PROFILE

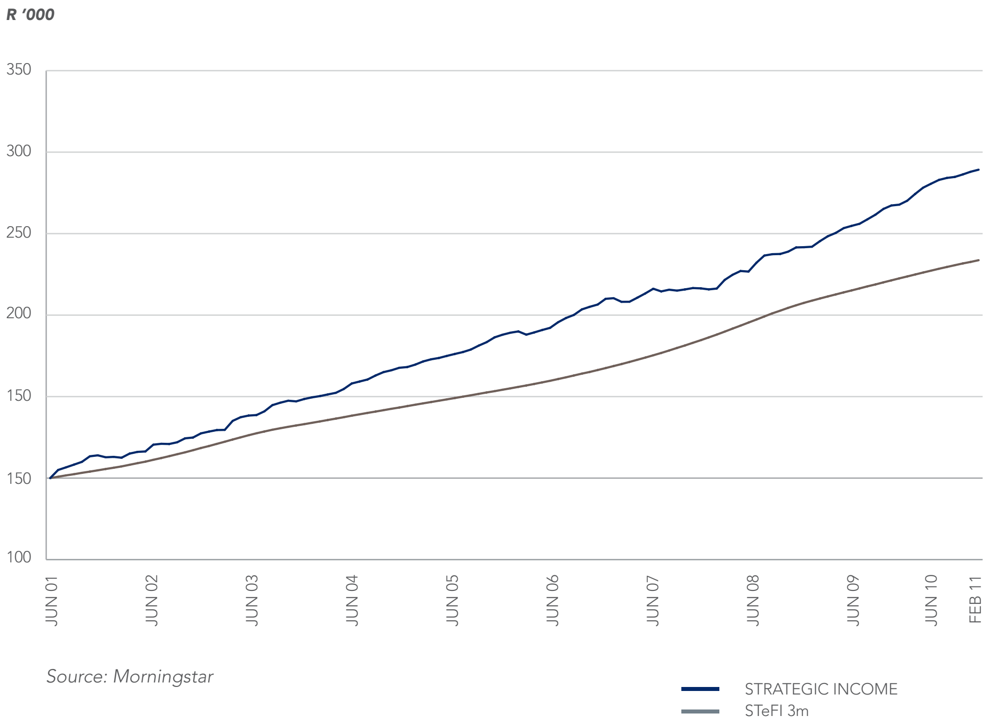
Strategic Income is suitable for investors who:

– are risk averse with a time horizon of 1 to 3 years, who require a regular stream of income from their capital base.
– seek managed exposure to income generating investments.
– believe in the benefits of active management within the fixed interest universe. (As illustrated in Figure 5, Strategic Income consistently outperforms the underlying asset classes in which it invests.) >

The fund is less appropriate for investors who:

– are looking for a short-term (less than 6 months) parking vehicle with higher yields than typically available in overnight bank deposits.
– seek a growing income to protect purchasing power against inflation with an investment horizon of more than 3 years.
– are averse to earning a major portion of their portfolio return in taxable interest-related income.

FIGURE 6.2 GROWTH OF R100 000 INVESTMENT AT INCEPTION IN JULY 2001



Source: Morningstar

OUR FIXED INTEREST FUND RANGE

Coronation offers a range of funds that cater for the majority of investors who are investing for immediate income. These funds share the common Coronation DNA of a disciplined, long-term focused and valuation-based investment philosophy and our commitment to provide investment excellence. See Figure 7.

FIGURE 7

A MORE CONSERVATIVE ALTERNATIVE TO STRATEGIC INCOME

Coronation Jibar Plus is a specialist portfolio with a risk profile that places it between our Strategic Income and Money Market funds. The key difference between Jibar Plus and the Money Market Fund is that the former aims to maximise yield while the latter focuses on earning a reasonable yield while first and foremost preserving capital. The Jibar Plus Fund therefore has a variable price, reflecting its less conservative investment stance. This fund will typically have a longer duration and term exposure than the Money Market Fund and may also have somewhat higher exposure to commercial paper.

It is still a low-risk fund, in that duration and term limits of 180 days and 720 days respectively apply, making it more conservative than a bond fund or even a managed income fund such as Strategic Income.

FEE DETAILS

	Coronation Money Market	Coronation Jibar Plus	Coronation Strategic Income
Launch date	October 1999	April 2000	July 2001
Fees (excluding VAT) Initial Fee Annual Management Fee[1]	Coronation: 0.00% 0.25%[2]	Coronation: 0.00% 0.45%[3]	Coronation: 0.00% 0.85%
Total Expense Ratio (TER)[4]	0.34% per annum	0.85% per annum	0.93% per annum
Advice costs (excluding VAT)	– Initial and ongoing advice fees may be facilitated on agreement between the Client and Financial Advisor. – An initial advice fee may be negotiated to a maximum of 3% and is applied to each contribution and deducted before investment is made. – Ongoing advice fees may be negotiated to a maximum of 1% per annum (if initial advice fee greater than 1.5% is selected, then the maximum annual advice fee is 0.5%), charged by way of unit reduction and paid to the Financial Advisor monthly in arrears. This annual advice fee is not part of the normal annual management fee as disclosed above. – Where commission and incentives are paid, these are included in the overall costs.		

1 A portion of Coronation's annual management fee may be paid to administration platforms like LISPs as a payment for administrative and distribution services.

2 The fee reduced to 0.25% from 0.30% (excluding VAT) from 1 September 2010.

3 The fee reduced to 0.45% from 0.75% (excluding VAT) from 1 September 2010.

4 The TER is calculated as a percentage of the average NAV of the portfolio incurred as charges, levies and fees in the management of the portfolio for a rolling 12-month period to end December 2010. A higher TER ratio does not necessarily imply a poor return nor does a low TER imply a good return. The current disclosed TER cannot be regarded as an indication of future TERs.

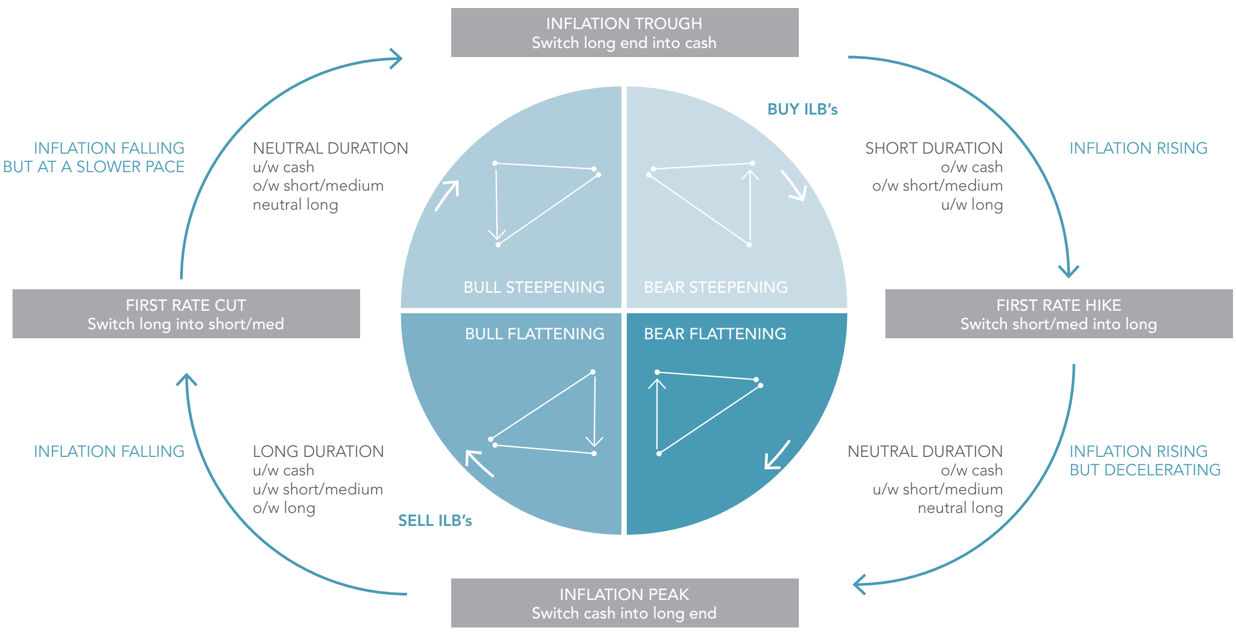
OUR APPROACH TO FIXED INTEREST

At Coronation we take an active approach to fixed interest portfolio management, with investment decisions driven by proprietary research across the full spectrum of potential return enhancers.

These include duration and yield curve positions, off-benchmark positions through inflation-linked assets as well as yield enhancement through credit enhanced assets. As is the case with equities, we believe value can be added through bottom-up security selection when mispricings occur. Critical to the success of our fixed interest funds is how we view changing market conditions and respond to this through active management of portfolio duration (a measure of the sensitivity of the market risk of the fund).

Our fixed interest investment cycle (as illustrated alongside) guides our duration management, asset allocation and yield curve positioning. In its simplest form, the cycle is divided into two halves which represent a falling inflation environment (good for bonds) and a rising inflation environment (bad for bonds). The other factors are nuances on this. While the chart looks neat and even, in practice the time taken to move through each quadrant can be very different.

FIGURE 8 THE FIXED INTEREST INVESTMENT CYCLE



AN EXPERIENCED AND BALANCED SKILLS SET

Our depth of skill across all asset classes is illustrated in the many publicly available ranking tables and performance surveys. Mark le Roux leads the eight person team of specialists who provide key inputs to extract maximum value from each of the potential return enhancers for the benefit of investors.

TEAM MEMBER	QUALIFICATIONS	WORK EXPERIENCE AND KEY ATTRIBUTES
MARK LE ROUX	BCom 20 years' experience	• Extensive Fixed Interest portfolio management experience • Started working in the market in 1991 on the trading desk at Old Mutual • Appointed Head of Fixed Income at Old Mutual Asset Management in 1997 • Joined a startup, Velocity Asset Management, in 1999 which was later bought by African Harvest • Joined Decillion in 2002 to start what is believed to be the first fixed income hedge fund (invested in by third parties) in SA, the Granite fixed income fund • Joined Coronation in July 2005 as Head of Fixed Interest • Currently manages a large number of institutional and retail fixed interest portfolios
CHANTAL VALENTINE	BCom(Hons) 19 years' experience	• Joined Coronation in 2003 as an economics and fixed interest strategist • Responsible for macroeconomic research and applying it to investment decisions • Previously worked as an economist with a particular focus on the bond market, including in the banking and stockbroking environments • Rated in the Financial Mail awards in both the Economics and Fixed Interest Research categories in every year she was eligible, including No.1 awards in both
TANIA MIGLIETTA	BBusSc (Finance), CFA 15 years' experience	• Joined Coronation in 2002 • Responsible for all money market, income and global cash portfolios as well as co-management of the Coronation Strategic Income and Preference Share funds • Won a Raging Bull award for the Coronation Income Fund • Member of the Coronation Credit Committee
STEPHEN PEIRCE	BA (Economics), MA (Finance), UKSIP 16 years' experience	• Joined Coronation in 2010 as a fixed interest portfolio manager • Extensive retail and institutional fixed interest portfolio management experience gained in the UK. • Previously worked at Societe Generale Asset Management in 2000 before moving to Royal London Asset Management in 2005
CHRISTINE FOURIE	FFA, BEconSc (Actuarial) 11 years' experience	• Joined Coronation in 2007 • Responsible for amongst others fixed interest structuring, inflation-linked bonds and liability matching • Previously worked on the equities and derivatives desk at Rand Merchant Bank for two years and product development at Momentum prior to that
ADRIAN VAN PALLANDER	CFA, FRM 9 years' experience	• Joined Coronation in 2002 as a quantitative analyst • Responsible for risk management and the monitoring of portfolio construction across all asset classes
LUKE HENKEMAN	BBusSc (Economics) 5 years' experience	• Joined Coronation in 2008 as fixed interest analyst • Responsible for credit analysis as well as other analytical and portfolio management responsibilities within the fixed interest team • Previously worked at JP Morgan Investment Bank as a corporate finance analyst in the Debt Capital Markets team
JONINE MOSTERT	BCom (Hons) 10 years' experience	• Joined Coronation in 2011 • Started working at Absa Capital in 1998, responsible for trading and managing the Fixed Interest derivatives desk • Joined the Bank for International Settlements based in Switzerland in 2003 where she managed the total euro interest rate risk portfolio for five years

Coronation client charter

We strive to always put our 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

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