

COROLAB

Your guide to investment ideas

THE INCOME AND GROWTH CHALLENGE

Featuring Balanced Defensive and Capital Plus

August 2011

CORONATION 
FUND MANAGERS

THE INCOME AND GROWTH CHALLENGE

Investors who are near or already in retirement face the most challenging of investor needs: simultaneously investing for both immediate income and long-term growth. The key challenge is to ensure a sustainable standard of living by balancing the needs of today with those of the future. The last 10 years have been very good to investors in local assets, and many retirees who expect a repeat of this experience may find that they are not positioned to cope with the tougher investment environment that is presently unfolding.

Given our lower long-term return expectations across all domestic asset classes, we believe investors with high drawdown rates and/or insufficient growth assets in their retirement portfolios may find themselves desperately vulnerable later in retirement.

In this issue, we discuss the most important considerations that investors with income and growth needs should take into account to ensure that their retirement planning is appropriately prudent.

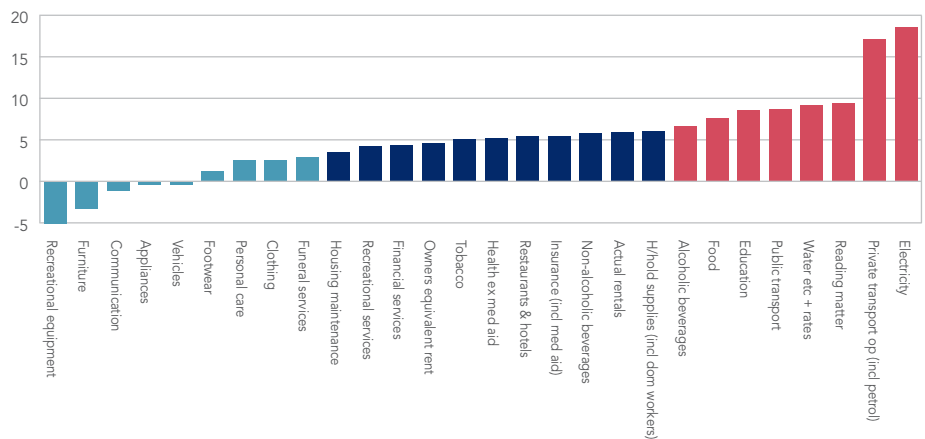
PLAN FOR HIGHER INFLATION

Headline inflation, as quoted in the media, is based on the 'average' South African's basket of goods. However, older individuals in the higher income categories often have disproportionate exposure to goods and services that are expected to increase faster than overall price levels.

Examples of these expenses include healthcare, municipal rates, water and electricity. Take for example healthcare costs, on average, these have increased 3% per year faster than headline inflation over the past decade. The significant investments that are required to maintain our country's ageing power and water infrastructure will also contribute to ongoing above-inflation increases in the cost of these basic services. Figure 1 illustrates how different spending categories influence the current inflation rate.

As such, the prudent planner would deem it only sensible to make provision for a higher personal inflation rate than that recorded in the headline number.

FIGURE 1 WHAT IS YOUR PERSONAL INFLATION NUMBER?



Year-on-year inflation rate for each category within the CPI basket as at 31 July 2011

Source: Coronation Fund Managers



PLAN FOR LOWER RETURNS

EXPECT INTEREST RATES TO REMAIN LOWER FOR LONGER

The growth momentum of the global economy has continued to slow through 2011, with the near-term outlook for economies across the developed world remaining negative. The dark clouds of unsustainable budget deficits and debt levels, coupled with a general loss of faith in the ability of politicians to deal decisively with these issues, will continue to sap market confidence for the foreseeable future. The severity of the unresolved debt problems facing the US is reflected in the commitment from the Federal Reserve to keep interest rates at current record low levels until at least the northern hemisphere summer of 2013.

While emerging market economies are generally much healthier than those of developed markets, their growth potential has also been curbed by the poorer outlook for developed markets. This is as a result of the close trading relationships between countries such as China and the US.

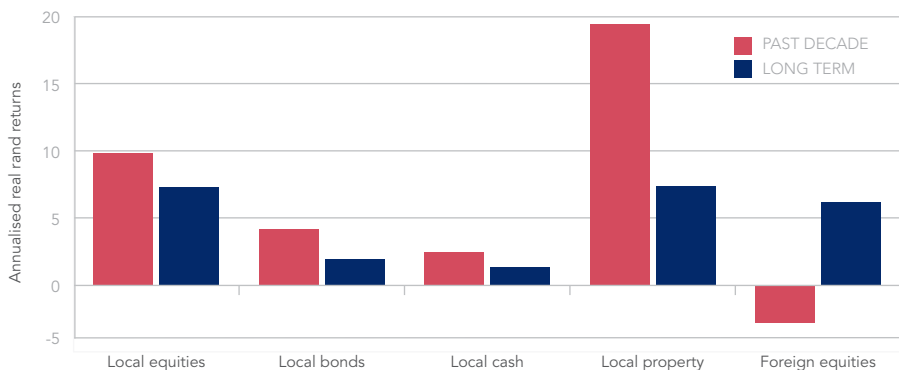
We believe that central banks will keep interest rates at exceptionally low levels for as long as necessary. While many fear deflation, we believe the risk of keeping interest rates at close to zero for an extended period of time and printing money will ultimately result in inflation coming through in future. The increased possibility of an enduring combination of slow growth, low interest rates and higher inflation creates an environment in which returns, from especially the income asset classes, are likely to be more subdued.

Against this background, we believe income and growth investors are at risk if they do not have enough growth assets in their portfolios. Growth assets are the most reliable means of protecting one's capital against the eroding effects of inflation.

THE LAST DECADE IS NOT A GOOD BASIS FOR EXPECTED RETURN FORECASTS

Investors in local assets have been handsomely rewarded over the last 10 years. Equities and listed property in particular have delivered very strong real returns, while cash and bonds also did well. However, in Figure 2, we show that these returns are in fact far ahead of their long-term averages and foreign equities are too far behind (as illustrated by the MSCI World Index).

FIGURE 2 ANNUALISED LONG-TERM TOTAL RETURNS PER ASSET CLASS
Past decade (to August 2011) versus last 111* years



* Shorter history for foreign equities (41yrs) and local property (31yrs)

Source: Deutsche Bank, I-Net Bridge, Triumph of the Optimists – Dimson, Marsh and Staunton



PLAN FOR LOWER RETURNS

Using the last decade's performance as a guide for future returns therefore offers a poor basis for prudent retirement planning in our view. To explain why we believe local assets are likely to revert to their long-term averages, one needs to consider the source of the last 10 years' returns.

Any asset class return consists of two parts: income and capital appreciation/depreciation. In turn, the capital appreciation/depreciation leg consists of growth in earnings (in the case of equities) or rentals (in the case of listed property) as well as the positive or negative effect of a re-rating of the asset class (in other words, how much more (or less) investors are willing to pay for an asset class).

Figure 3 shows that local shareholders benefited from company earnings that grew significantly faster than South Africa's overall GDP (6.3% after inflation for the All Share Index versus 3.4% for the economy), partly as a result of a non-repeatable decline in tax rates and muted real wage growth. While equities have enjoyed a positive re-rating of 1% p.a. over the last 10 years, the impact of earnings growth on the asset class's total return has been far greater.

FIGURE 3 ASSET CLASS RETURN ATTRIBUTION FOR THE PAST 10 YEARS
To August 2011

	ALL SHARE INDEX	LISTED PROPERTY	ALL BOND INDEX
TOTAL RETURN	16.7%	20.8%	10.7%
EARNINGS (DIVIDENDS, DISTRIBUTIONS OR COUPONS)	3.5%	11.0%	10.3%
CAPITAL GROWTH	13.2%	9.8%	0.4%
– EARNINGS/DISTRIBUTION GROWTH	12.3%	5.6%	–
– RATING	0.9%	4.2%	0.4%
INFLATION	6.0%	6.0%	6.0%

Source: I-Net Bridge and Deutsche Bank

We believe that for company earnings to grow at a rate faster than the economy in which they operate is unsustainable, and we therefore expect lower returns from this asset class over the next 10 years.

Investors in income-generating investments such as bonds, and particularly listed property, benefited from a structural re-rating made possible by a large decline in inflation and interest rates over the 10-year period. For this effect to be repeated, inflation in SA would need to fall to the 2%–3% range over the next 10 years. This we believe is unlikely given that distributions (in the case of listed property) and coupons (in the case of bonds) have already come down from the levels of 10 years ago.

We believe that for prudent retirement planning, investors need to assume a de-rating of these asset classes, rather than a re-rating.

PLAN FOR LOWER RETURNS

In Figure 4 we provide our 10-year forecast of what the different asset classes are likely to deliver, solidifying why we believe it prudent for income and growth investors to have sufficient exposure to growth assets in their portfolios.

FIGURE 4 10-YEAR FORECAST FOR LOCAL AND OFFSHORE ASSET CLASSES

	PAST 10 YEARS*	10-YEAR FORECAST**
GROWTH ASSETS		
LOCAL EQUITY	16.7%	9-11%
GLOBAL EQUITY	2.3%	13-15%
LOCAL PROPERTY	24.3%	8-10%
INCOME ASSETS		
LOCAL BONDS	10.7%	8-9%
GLOBAL BONDS	5.8%	5-9%
LOCAL CASH	8.9%	7-8%
INFLATION	6.0%	6%+

* Past 10 years to 31 August 2011

Source: I-Net Bridge, Deutsche Bank, **Coronation Fund Managers

PLAN TO LIVE LONGER

While it is rather unsettling to think of one’s own mortality, most of us underestimate the investment horizon that needs to be planned for in retirement. Advances in healthcare technology and improvements in nutrition mean that people are living longer, and therefore life expectancy is increasing.

For example, if you are a South African female retiring at 65, you can expect to live a further 20 years (see Figure 5 below). But your effective time horizon may be longer as you may live beyond the average retiree.

The prudent approach would therefore be to plan your affairs to have a sustainable income for at least 25–30 years. At a 6% inflation rate, this means that you will require nearly 6 times (allowing for inflation) the level of income at the end of your planning horizon than at the start, just to be able to buy the same amount of goods and services.

FIGURE 5 SOUTH AFRICAN LIFE EXPECTANCY AT RETIREMENT AGE

RETIREMENT AGE	MALE	FEMALE
60	81	84
65	82	85
70	84	86
75	85	87

Source: Actuarial Society of South Africa



WHAT ARE THE IMPLICATIONS FOR RETIREMENT PLANNING?

We have shown so far that the typical retiree needs to plan for a horizon of 25–30 years, can expect a relatively high inflation rate and, for at least the next decade, should expect returns to be more subdued than those of the past 10 years. The prudent planner's response to this backdrop will include moderating income drawdown rates and ensuring that post-retirement portfolios have the appropriate balance between growth and income assets.

THE NEED FOR GROWTH ASSETS

To illustrate why we argue for the inclusion of growth assets in a post-retirement income portfolio, consider the 'actual impact of inflation analysis' in Figure 6. This table compares the actual results that would have been achieved by investors drawing different levels of income from two portfolios with differing risk profiles. The first option is a very conservative income assets-only portfolio, and the second a moderate risk income and growth portfolio, with a roughly even split between income and growth assets over time. We have used the average money market fund for the former and the Coronation Capital Plus Fund as an example of the latter. The analysis is performed for the period July 2001 (when Capital Plus was launched) to 31 August 2011. Over this period, the average money market fund returned 9% p.a., with a very low standard deviation of 1%, while Capital Plus returned 14.4% p.a. at a standard deviation of 7.6%.

The first point to note is how quickly inflation erodes purchasing power. The table indicates that, if you drew an annual income of R70 000 in 2001, you need R130 103 to buy the same basket of goods and services today. The second point is that Capital Plus (the portfolio with roughly 50% invested in growth assets) was a lot more effective in generating income over the period regardless of the initial income rate selected. For example, if your initial income rate was set at 7% in 2001, you need to draw 10% from Capital Plus today, while your income requirement from an average money market fund would be 16% – approaching the maximum drawdown rate for a living annuity of 17.5%.

FIGURE 6 ACTUAL IMPACT OF INFLATION ANALYSIS

INCOME RATE IN 2001	3%	5%	7%	9%
Capital invested in 2001	1 000 000	1 000 000	1 000 000	1 000 000
Annual income in 2001	30 000	50 000	70 000	90 000
Annual income in 2011 (effect of actual CPI)	55 759	92 931	130 103	167 276
Capital in 2011, if invested in MMF	1 442 000	1 084 100	815 000	612 000
Capital in 2011, if invested in Capital Plus	2 372 000	1 784 000	1 340 000	1 007 000
INCOME RATE IN 2011				
Coronation Capital Plus	2%	5%	10%	16%
Average money market fund	4%	9%	16%	MAX*

* MAX = 17.5%

Note: Analysis includes 115 bps allowance for platform and advice costs

Source: Coronation Research


WHAT ARE THE IMPLICATIONS FOR RETIREMENT PLANNING?

Drawing too high an income at the start of your retirement and/or expecting too high a rate of return is as dangerous as investing too conservatively. Consider the 'income rate and return analysis' in Figure 7. This table shows a variety of possible initial income rates, from 2.5% to 17.5%. This range represents the current legal drawdown limits applicable to living annuities. It also shows a variety of potential annualised net investment returns that may be earned, from 2.5% to 15%, in each column.

Each cell in the resulting table represents the number of years before income (adjusted for inflation of 6%) will start declining. Another way to think about this is how many years you have before your standard of living will start to decline in the different scenarios. At a rate of return of 15% p.a. (historically achieved by Capital Plus), any initial income rate up to 7.5% represents a sustainable income, as income will continue to grow in line with inflation for at least 50 years. However, note what happens when the expected return drops by 2.5% and 5%: the period of sustainability drops dramatically to 22 and 13 years respectively at a drawdown rate of 7.5%.

Given our expectation for lower returns, we do not believe that initial income drawdown rates above 6% will be sustainable for most retirees (and then only from a portfolio with adequate exposure to growth assets.)

FIGURE 7 INCOME RATE AND RETURN ANALYSIS


 Many retirees are drawing 7.5%–10% and expecting returns of 12.5%–15%. Note how sensitive their income security is to a 2.5% decline in expected return.

		NOMINAL NET INVESTMENT RETURN P.A.					
		2.5%	5.0%	7.5%	10.0%	12.5%	15.0%
SELECTED INCOME RATE P.A.	2.5%	21	30	50+	50+	50+	50+
	5.0%	11	14	19	33	50+	50+
	7.5%	6	8	10	13	22	50+
	10.0%	4	5	6	7	9	20
	12.5%	2	3	3	4	5	7
	15.0%	1	1	2	2	2	3
	17.5%	1	1	1	1	1	1

Source: Asisa Standard of Living Annuities with additional calculations by Coronation Research

THE IMPACT OF THE SEQUENCE OF RETURNS

We have now argued the need for growth assets in an income and growth portfolio. But outcomes will not be optimised by investing only in shares and property as the returns on growth assets can vary from year to year. For example, the local equity market achieved its average return of 16.7% p.a. over the past decade at a standard deviation of 20%. The standard deviation reflects the wide range of calendar year returns achieved by the market over this period, from a high of 46% in 2005 to a low of -23% in 2008. Studies show that the sustainability of a retirement income plan is most often optimised with a standard deviation of 10% or less.



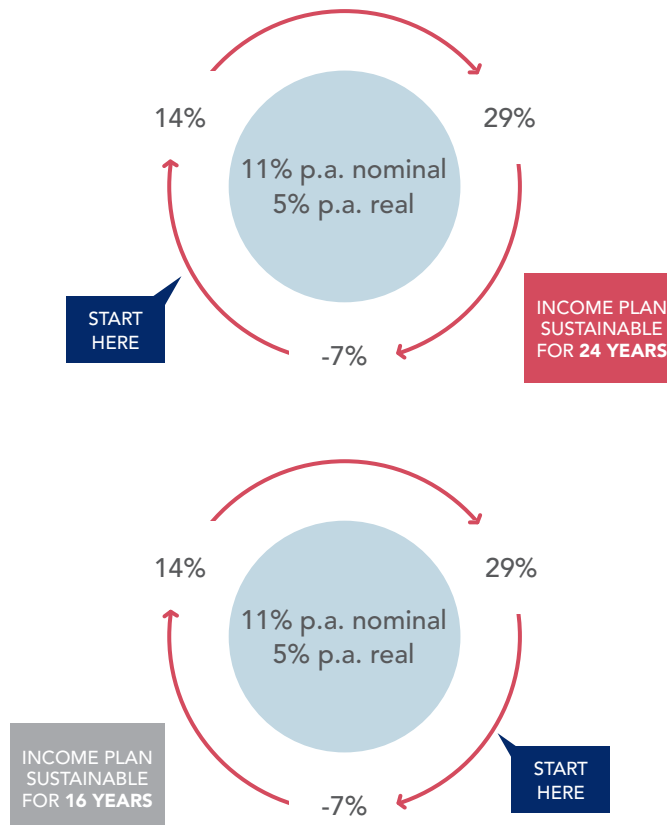
WHAT ARE THE IMPLICATIONS FOR RETIREMENT PLANNING?

The reason why volatility of returns should be moderated is because the sequence of returns matter. If the value of your investment declines just after you start your drawdown programme, the income withdrawn will represent a larger portion of your assets than if you had experienced growth over the same period. This means that in future years you will need to draw a larger portion of the remaining capital to achieve the same level of income.

The importance of the sequence of returns is best illustrated by means of an example (see Figure 8).

Consider a portfolio that returns a nominal 11% per annum and a starting drawdown rate of 7% which adjusts annually by inflation of 6%. This annualised return of 11% is made up of calendar year returns of 14%, 29%, and -7% respectively, which repeats in the same sequence for the entire investment horizon. If you first experience the two years of positive growth before suffering the 7% loss in the third year, your retirement plan will be sustainable for 8 years longer than if you were unlucky enough to experience the 7% loss in your first year of investment (before the two years of gains).

FIGURE 8 IMPORTANCE OF THE SEQUENCE OF RETURNS



Assumptions: Starting drawdown rate = 7% adjusting annually by inflation of 6%
 Sustainability period measured to year when maximum annual drawdown rate = 17.5% (ILLA MAX)
 Annual return series repeat in same order for full period of retirement

Source: Coronation research (Acknowledgement GAO; Milevsky & Macqueen)



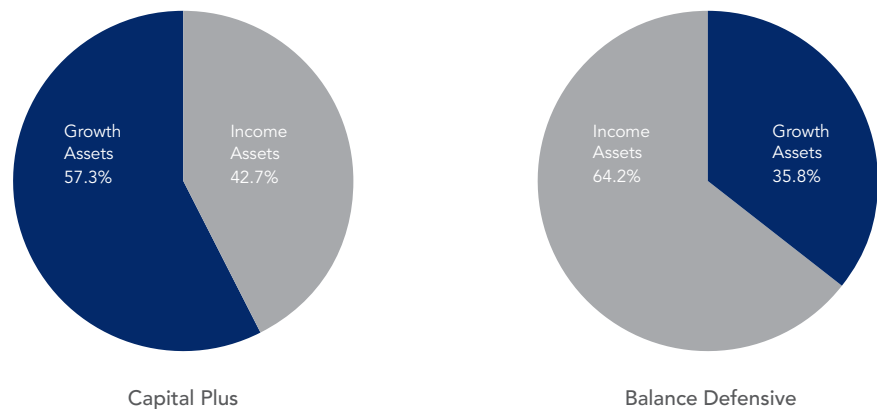
CORONATION'S INCOME AND GROWTH SOLUTIONS

Coronation offers two funds that meet the needs of income and growth investors – **Balanced Defensive** and **Capital Plus**. These funds' risk budgets are designed to provide optimal outcomes by balancing the quest for attractive levels of real return over the long term with minimising the risk of capital loss over the short term.

The Balanced Defensive Fund can invest a maximum of 40% in growth assets and is managed to deliver positive returns over any 12-month period with a high degree of probability. It is consistently one of the top performers in the Asset Allocation – Prudential Low Equity Category. Since inception in February 2007, Balanced Defensive has produced a nominal return of 9.6% p.a. (or 2.3 p.a. in real terms) at a standard deviation of 4.1%.

The Capital Plus portfolio has a unique risk budget and is optimised for income and growth investors with longer time horizons. Up to 60% of the portfolio can be invested in growth assets and despite its larger risk budget, the portfolio also aims to preserve capital over any 12-month period. It has produced a nominal return of 14.4% p.a. (or 8.1% p.a. in real terms) since its inception in 2001 at a standard deviation of 7.6%.

FIGURE 9 ASSET ALLOCATION AS AT 31 AUGUST 2011



Both Capital Plus (LHS) and Balanced Defensive (RHS) have appropriate risk budgets for income-and-growth investors.



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

* Disclaimer

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