

corospondent

The Coronation Fund Managers Quarterly



Resolutely focused



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October 2008

CORONATION 
FUND MANAGERS

Babe Ruth and Lehman Brothers

do the FINDI RESI shuffle

What an incredible difference a few months can make. In the last *Corospondent* I was making the point that, like everybody else, we were going through a difficult time, but that this was normal and that what really mattered was sticking to one's knitting. I was also at pains to convey the fact that circumstances would not necessarily change in a heartbeat. Well, I was wrong. In the last three months the FTSE/JSE Resources 20 Index (RESI 20) has nearly given up all its gains year-to-date, by falling 32%. During the same period the FTSE/JSE Financials + Industrials 30 Index (FINDI) has remained essentially flat. The narrowness I spoke of may well be over. Happily all of our client portfolios have benefited handsomely from this change.

RESI THRASHES FINDI TO END JUNE 2008



HUGO NELSON
CHIEF EXECUTIVE OFFICER

FINDI MAKES A COMEBACK



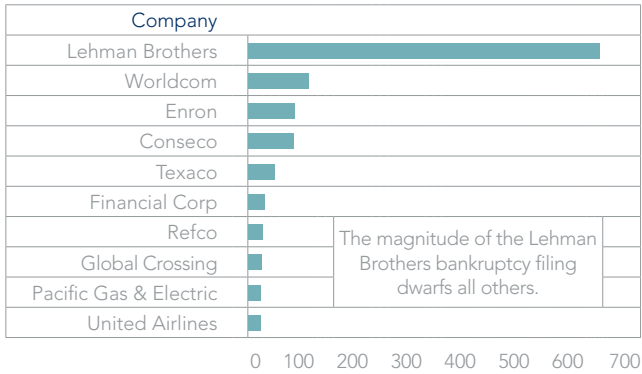
There are two points which flow from these developments:

- 1 Valuation matters, not sentiment
- 2 Certain decisions can have very long-term implications

On the first point, the relative FINDI strength occurred in the wake of a complete meltdown in global financials and entrenched recessionary fears. Conclusion, the FINDI was just too cheap. This year we have seen three 100-year-old institutions disappear – Bear Sterns, Lehman Brothers and Merrill Lynch, with the last two exiting in the past quarter, and yet the FINDI outperformed the RESI. It is worth noting that Lehman is the largest chapter 11 bankruptcy filing by a long way.



TOP 10 CHAPTER 11 US BANKRUPTCY FILINGS



Source: www.chartoftheday.com

Pre-bankruptcy assets (US\$ billion)

On the second point, I recently read a fascinating anecdote in philosopher, Antony Flew's, *There is a God*: '...He had been the league's premier player, first as a pitcher and then as a position player who hit twenty-nine home runs, while also pitching in seventeen games, in 1919. And then Boston Red Sox owner Harry Frazee, who some say needed cash to finance a Broadway

play, sold George Herman 'Babe' Ruth to the New York Yankees for US\$125 000 and other considerations. Ruth went on to lead the Yankees to seven American League pennants and four world championships. The Red Sox would not win their next World Series title until 2004, eighty-five years later.'

Now, while correlation does not imply cause and effect, I would agree with Flew in concluding that the actions of Harry Frazee in selling Ruth negatively impacted the Red Sox for 85 years! The Yankees on the other hand benefited handsomely by going long Babe Ruth. When the market starts to broaden from an incredible narrowing as we witnessed at the end of June 2008, the impact can be quite long lived for client portfolios. For the sake of our clients, I certainly hope so.

Let me conclude with a quote relating to the current credit crisis which is addressed very comprehensively elsewhere in this edition of the *Corospondent*: "The most important thing I can say about financial panics is that they are all temporary – they either die of exhaustion or are overwhelmed by the heavy artillery of government policies." – Stephen S Roach, Chairman, Morgan Stanley, Asia. 🇺🇸

Confidence crisis

The world will certainly not be the same, at least not for as long as memories are reasonably fresh

by NEVILLE CHESTER

We are living in historic times, which will be the subject of many books and doctoral theses to come. The demise of global institutions such as Lehman Brothers, Merrill Lynch and Bear Sterns (among many others), believed unthinkable a year ago, has happened with remarkable speed. But how did it all go so horribly wrong? What started as failure in subprime debt markets has spread rapidly, bringing down banks and financial institutions from Australia to Iceland. This is no longer about subprime credit; it is about confidence – the underlying, unspoken backbone of the global financial system.

What enables you and me to happily allow an institution to take our hard earned salary every month? The answer is confidence – the confidence that tomorrow in a branch or at an ATM we have ready access to our money. In a similar fashion, albeit on a much larger scale, pension funds, institutional money managers and deposit-taking banks parcel out trillions of dollars to banks on a daily basis, sound in the knowledge that it can be accessed on immediate notice. It is this confidence that has been broken. Despite what the media in the US may proclaim, the damage has gone far beyond the fat cat bankers and shareholder bail-outs. It has gone to the very core of the global financial system. There is no doubt that a systemic crisis is building. To avoid contagion across other industries and into the lives of ordinary people, immediate action, as is happening, is required.

It is now evident that the root cause of the problem was the low levels of interest rates, brought about by the previous bubble explosion (the IT sector) and the disastrous events of September 2001. It was into this fertile soil that the seeds of the crisis took hold.

Very low interest rates encouraged the initial asset price inflation which saw house prices increase at a rapid rate, not just in the US but around the world. This was facilitated by reasonably easy access to credit at attractive rates, courtesy of the US Fed and central banks in other major economies.



NEVILLE CHESTER is a senior portfolio manager responsible for the management of aggressive equity portfolios, the Coronation Market Plus and Equity funds. He also manages the Coronation Top 20 Fund.

At the same time, investors were faced with the prospect of very low levels of return on their interest-bearing instruments given such low levels of interest rates. In response to this dilemma, investors started to increase their level of risk by investing in credit and emerging markets as they shopped for higher returns. Risk appetite started expanding and in the competitive environment of money management, pretty soon everyone was competing for higher returns with commensurately increasing appetites for risk.

Investment banks, never shy to take advantage of an opportunity, identified this heightened risk appetite and, as with any good capitalist society, where there is demand supply will surely come. Given the appetite from pension funds, endowments and especially hedge funds for higher yields on their investments, investment banks and specialist financial boutiques created products that would earn better returns in a low interest rate world.

Securitisations, collateralised debt obligations (CDOs), CDO squareds, credit default swaps (CDSs) and a whole alphabet soup of products were manufactured, tailored to suit the underlying assets and their clients' increased appetite for risk. But it was not only the investor who benefited; the actual borrower also gained. The demand for these higher-yielding instruments was such that it started pushing down the interest rates that people were prepared to charge for riskier lending. Whether you were a third-world government, a highly geared industrial company, a highly leveraged private equity deal or, as we all famously know now, an out-of-work migrant labourer in the southern states of the US; people with large cheque books were suddenly presenting you with great big wads of cash in return for a relatively low rate of interest.

Obviously, when presented with such largesse, these borrowers did what came naturally and accepted these loans in ever increasing quantities. No deal seemed too risky and no collateral too shaky to be lent against at all-time low credit spreads.



As it all started unwinding when the housing bubble burst, I will focus on subprime lending. With the growth in demand for these types of assets, a vast origination industry sprang up out of nothing. These originators of loans never took the loans onto their own balance sheet, and as a result paid no heed to the quality of business which they wrote or to the ability of the borrower to repay. Heavily incentivised to write business at all costs, this is exactly what they did. Playing aggressively in the subprime loan market, where loans were granted to individuals with poor credit records, agents scoured the US granting loans to meet the insatiable demand for higher yielding loans from banks and institutional investors.

Watching over all of this were the ratings agencies, whose role is to provide the institutions with the confidence to buy up this paper and lend the money. Most investors have specific credit limits and rating thresholds which determine what type of investments they are allowed to hold. AAA debt is the best quality and the rating given to US government debt. From there on it declines in increments until one ultimately gets junk grade debt where the risks of default are high and the chances of an investor losing his capital are high. As one would expect, the return earned on high-quality debt is lower than that earned on more speculative debt. Together with the investment banks, the ratings agencies devised complicated structures, based on statistical and actuarial models that enabled one to rate large portions of these loans as AAA, despite the higher yields and arguably the greater risks which lay hidden in the portfolios. In fact, many commentators have used the analogy of alchemy, the art of turning ordinary items into gold. As we all know, no such thing exists. In exchange the ratings agencies were also handsomely rewarded by the investment banks and debt issuers for these independent ratings – ratings upon which investors based their investment decisions.

So in this perfect world one had ever growing demand for houses, ever willing lenders prepared to give borrowers cash and ever willing financial institutions to pick up these high yielding loans that were rated investment grade. The trigger for it all to start unwinding was the start of tighter monetary policy. The excess liquidity worldwide did not only create bubbles in property. Resource prices started climbing dramatically across the globe as the high levels of growth demanded more resources, and investors emboldened with this new appetite for risk and low borrowing costs decided to invest into physical commodities. This all started to feed through into actual inflation (unfortunately house price rises never fed into inflation, the measure used by central banks to control interest rates). Concerned central banks, on seeing this commodity price-led inflation, started tightening interest rates.

In the US, interest rates rose from 1% to 5.25%, placing enormous pressure on the housing market. Simultaneously record levels of new houses were coming onto the market from builders that were responding to the high levels of housing demand. The classic scenario for a bubble to be pricked – waning demand and increasing supply which accentuate the peaks and troughs of cycles. As more and more borrowers got into trouble, the forced liquidation of their properties put more pressure on the housing market, creating a vicious circle. The first real sign of trouble in the financial world was when Bear Sterns refused redemptions from a couple of their hedge funds which had exposure to subprime assets in August 2007. Since that time it has been a roller coaster of high-level collapses, bail-outs, capital raisings and bank failures.

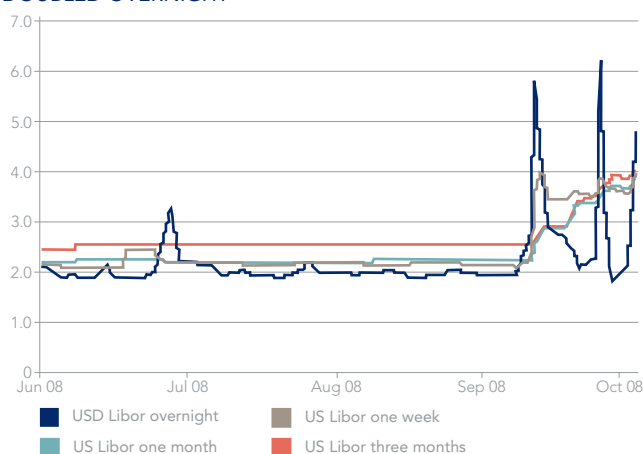
This was the initial phase of the crisis. It has since moved on from subprime home loans to the inherent trust in the financial system. Aided and abetted by aggressive short sellers, some of whom were prepared to spread malicious rumours to facilitate their positions, financial markets began speculating about which banks were in trouble and which would be the next to go. Unlike industrial businesses that sell physical products, the share price and general perception over its financial well-being can drive the success or failure of a bank. As a bank's share price declines and rumours swell over its capital adequacy or ability to raise funding, depositors (both professional and private) start to allocate their funds away from the troubled bank. This exacerbates an already difficult situation and within weeks a bank can be in serious financial difficulty. The nature of a bank's business is to lend long (i.e. lend money for long periods) and borrow short (most bank deposits are repayable within a year). Just think of a mortgage loan which makes up a large percentage of a bank's assets. The usual term is 20 years (and can go out as far as 30 years). No one wants to have his money locked up on deposit for 30 years! The core premise of funding a banking book is that the depositors will continue to leave their money with the bank for long periods of time, even though they could withdraw it at short notice should they so wish.

Typically this confidence has been in place for many years, and even if an individual bank did run into difficulty this trust was not damaged. The telling blow that has shaken this trust amongst banks was the failure of Lehmans. With hindsight, this bank should never have been allowed to fail completely. With outstanding debt of US\$600 billion and counterparty transactions in all major economies, its failure shook the very foundations of the global financial industry. Lehmans was allowed to fail in an attempt to prove to the world (in an important election year) that the US remained a strongly capitalist society, and risk taking meant exactly that. But to let the bank fail completely rather than just shareholders lose all

their capital, meant that no one was too big to fail and that all counterparty exposures should be viewed with distrust.

The measure of trust in the banking system is the interbank rate. This is the rate at which the banks are prepared to lend to each other. In both the US and Europe this rate has soared to many times above the base lending rate – illustrating how banks are effectively pricing themselves out of the market to avoid taking on another bank's lending risk.

US\$ LIBOR THE COST OF INTERBANK LENDING DOUBLED OVERNIGHT



What this now means is that even banks that are solvent and don't necessarily have subprime issues are starting to fail. In Europe a number of banks which are highly leveraged are coming under pressure and already a couple of countries have taken the unusual step of guaranteeing all deposits to allay depositor fears and keep the banks afloat.

The impact is rapidly moving from the financial sector to other parts of the economy. As financing dries up, economic growth is slowing rapidly. The ability to access financing is the life blood of many economies. Without it they will cease to function. This is why the bail-out or funding efforts by governments are crucial to the economic well-being of all businesses around the world. Make no mistake; the next decade will be vastly different to the last. Credit will be less easily available and will cost much more. Some impact is unavoidable, but at the moment no lending is taking place at any price; it is this which needs to be remedied.

The recently announced plan in the US to buy up to US\$700 billion of subprime assets from bank balance sheets is a good start to de-risking the US environment and start to build trust in the sector. The UK plan to pump £50 billion of


capital into their sector and provide funding lines of a further £250 billion is a more drastic but also very strong measure to ensure counterparty security. A host of other measures are also being taken in Europe. The fact that none of these have resulted in any restoration of confidence shows how far gone the lack of trust is and how serious the situation has become. Delays in implementation and the failure of bureaucrats and technocrats to fully appreciate the magnitude of the problem have exacerbated it to the point that it is very difficult to kick-start the financial sector once again.

The impact on South Africa

South Africa and a couple of other emerging markets have become beacons of stability in what is a very shaky world. While a number of reasons are given for this, it primarily comes down to exchange controls. This has had two benefits; firstly, none of the banks' South African operations had any exposure to subprime assets as the controls prevented the purchase of such assets. This has protected capital and prevented investors from being concerned about holes in the balance sheets. Secondly, it has meant that South African banks have very little foreign funding. The majority of their funding comes from South African depositors who have no other choice of banking institution, and foreign lenders have never put much funding into the system. Thus the global panic has left the South African banks reasonably unaffected from a funding perspective. It will however reflect in the cost of bank capital and senior debt as equity prices and bond markets respond in sync with what is happening around the world. The trend to price credit appropriately will be felt here as much as it will be around the rest of the world.

The unwinding of the excess leverage is deflating a number of bubbles. We are seeing huge price decreases in physical commodities as the unfounded expectation of perpetual commodity price growth comes unstuck. This is also having an impact on South Africa given that we are a large exporter of commodities, although some of this is offset by our energy imports.

Conclusion

The world will certainly not be the same, at least not for as long as memories are reasonably fresh! The economic outlook for the world is poor although the extent to which this is already reflected in global equity prices is up for debate. South Africa, through large measures of good luck rather than careful planning, has managed to avoid the excesses which have placed the world in such dire straights. This, allied with the continued infrastructure development and likely reduction in interest rates into 2009, should mean we will come through this period a lot stronger than many other regions, with a solid banking industry intact. 

Equity market update

Put emotion aside and focus on the opportunity on offer

by KARL LEINBERGER

Markets remain very challenging. The current environment will go down in history as one of the great crises of the modern era. Credit is the oxygen that feeds economic activity. With the credit crunch as far advanced as it is, there can be no doubt that many countries will go into recession. Even the emerging economies, thought by many to be immune to the woes of the developed world, now appear unlikely to escape unscathed.

To add salt to the wounds, this downturn is unlikely to be short and sharp (as was the case in 1987, the early 1990s, 1998 and the early 2000s). One should not underestimate the impact that deleveraging will have – consumers around the world are geared to overpriced houses and this will take years to correct.

On a more positive note, regulators and governments are now united in their resolve to get 'ahead of the curve' and restore confidence in the system. Ad hoc solutions are no longer working, systemic solutions are required. We therefore expect more deposit guarantees, further recapitalisation initiatives (outside the US) and synchronised rate cuts. The good news is that we think that the crisis will pass. The global economy is much better balanced than it has been for many decades.

In times of crisis, allocators of capital look for opportunity. While many will argue that the current environment calls for a focus on a return of capital (i.e. cash), we think that the opportunity for the long-term investor lies in equities (a return on capital). As we commented in the June quarter, we believe that buying quality assets at low prices is the route to wealth creation. The pendulum has swung from greed to fear. Investors have capitulated – they are now giving equities away with little regard for valuation. We do not expect the macro environment to improve in the near term. We also have no idea when markets will turn. But we do know that equities are cheap. It has been 20 years since global equities traded at such low ratings and the margin of safety is now large.




KARL LEINBERGER is chief investment officer and a member of the executive committee. He currently manages the Coronation Equity Fund and is co-manager of the Coronation Houseview Portfolios and Coronation Balanced Plus Fund.

Equities declined by 21% in the quarter (resources -38%, financials +12%, industrials -4%). It was somewhat of a watershed quarter for Coronation in that it vindicated our long-held view that commodities were overvalued. We had no special insights into what was coming. Our advantage lay in our investment philosophy – an uncompromising commitment to the long term. Commodities are notoriously cyclical. Whenever investors talk of structural change, beware of the cycle! To this day we are amazed at the capital around the globe that poured into commodities eight years into the biggest commodity bull market in history. That said, the sell-off has now been so severe that we are now seeing good value in selected commodity counters. BHP Billiton has demonstrated over the years the superior quality of its assets (low cost, long life) and its management team. The share has declined by close to 50% as commodities have sold-off. The company now trades at 5.5 times current year earnings and 11.4 times our assessment of mid-cycle earnings.

In a single quarter banks have gone from being reviled to being loved. The relative performance of banks to resources in the quarter was a 5 sigma event, comfortably fitting the definition of a fat tail. Once again, we had no special insights – just the broad shoulders to recognise that quality franchises, with excellent management teams trading at 5.5 times their earnings, presented an excellent buying opportunity (even with the interest rate cycle against you).

We have seen dramatic moves in domestic counters (Mr Price +48%, Absa +35%, Aspen +33%, Truworths +30%) as investors have come to realise that a lot of the bad news was in the price and that South Africa is one of the few countries that moved early with rate hikes. While we have kept the DNA of our portfolios very much intact, we have taken some profits in domestic counters and invested it in selected resource counters (mainly the diversified miners, whose diversification across commodities and producer currencies is attractive at this point in the cycle).

MTN declined by 8% in the quarter. In the past we have been uncomfortable with the premium one had to pay for its growth prospects. This premium has disappeared in the emerging market sell-off and we have now acquired a substantial position in the stock.

In conclusion, while we acknowledge that it is not easy, we strongly encourage investors to put emotion aside and focus on the once-in-a-generation opportunity that markets are currently offering the long-term investor. 

The local bond market

The swift turning of the tide

by CHANTAL VALENTINE

The bond market (ALBI) has returned 6% over the past 12 months, with most of that return being made in the past three months. Over a one-year period, returns were strongest from shorter-dated bonds, but more recently much better returns have been seen from the very long end of the maturity spectrum. Looking back 12 months, bonds were the worst performing segment of the fixed interest universe, returning half of what cash returned and lagging even further behind the performance of the inflation-linked sector (+16.2% over 12 months). Again, the tables have been turned more recently, with bonds outperforming cash and, by an even larger margin, inflation linkers over the past quarter and even the past six months.

BOND AND MONEY MARKET RETURNS TO SEPTEMBER 2008

	3 months %	6 months %	12 months %	Year-to-date %
All Bond	12.6	7.1	6.0	5.1
GOVI	12.0	6.8	6.3	5.2
OTHI	15.3	8.0	3.8	3.5
Bonds 1 – 3 years	6.7	5.3	8.5	7.0
Bonds 3 – 7 years	11.6	6.3	5.5	5.1
Bonds 7 – 12 years	13.4	7.0	5.4	4.5
Bonds 12+ years	19.9	9.7	2.9	2.5
Cash	3.1	6.1	12.0	9.1
Barclays BESA Government Inflation-linked Bonds	(1.4)	4.6	16.2	10.2

Source: Deutsche Securities



CHANTAL VALENTINE joined Coronation as economic and fixed interest strategist in 2003. With 16 years' experience in analysing local and global markets, she plays a critical role in the investment decision-making process.

Bond yields were probably too low by the start of the last quarter of 2007, and rose steadily through the next nine months (to eventually reach levels which were undoubtedly cheap). Much of the period was characterised by rate hikes, with the MPC raising rates in October and December 2007. There was a brief respite in January 2008, when it seemed that downside risks were abating, but that didn't last long. A nasty combination of factors were soon felt, including a relatively sharp rand weakening and renewed increases in oil and food prices; these saw the MPC decide to raise rates again in April 2008, and they followed with a similar move in June before pausing once more in August.

SA BOND YIELDS



Source: I-Net Bridge



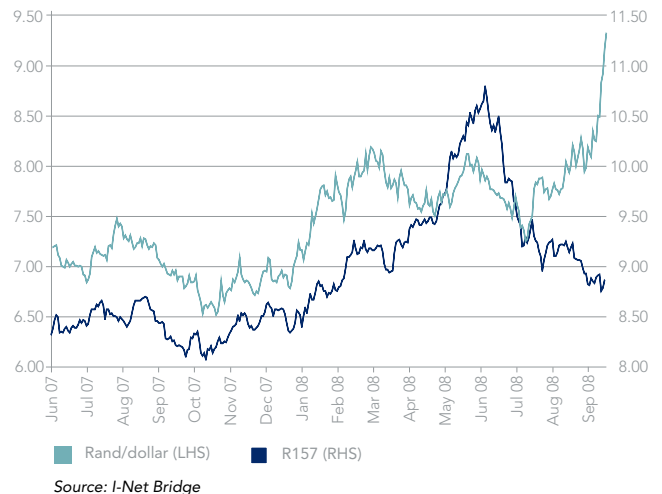
All this took place against an increasingly nervous global background, as the credit crunch steadily intensified throughout this time. The global picture shifted from worries over subprime in the final quarter of 2007, to the Northern Rock nationalisation and Bear Sterns sale in the first quarter of 2008, and so on through to the far starker manifestations seen by the past quarter, when Freddie Mac and Fannie Mae went into conservatorship and there was a wave of US banks either failing (Lehmans being the most notable) or being bought up to prevent that. The 'crunch' part of the phrase hit home, with not only consumer and corporate credit being affected, but interbank lending drying up as well. A number of (increasingly interventionist) measures by central banks were implemented to try un-jam the markets, and the authorities have also become involved in propping up the banks, in a number of different measures in various regions. The crisis has certainly not played out yet and it remains to be seen how effective these measures will be, and to what extent more may yet be needed.


Needless to say, this kind of background was very unsupportive to risky assets, and was part of the reason that the rand fell (especially in light of concerns over funding the large current account deficit). We also saw the EMBI spread widen, although on the other hand US Treasuries benefited from a flight to quality. The effects of all this on local bonds were to see the curve move up by over 200bp between October 2007 and June 2008. Yet, when sentiment turned, it turned fast. The past quarter's rally was initially prompted by the announcement of the reweighting and rebasing of the CPI, expected to lead to a sharp fall in measured inflation in 2009; and was backed up by falling oil and food prices also leading to a better inflation outlook. The money market saw the FRAs pricing in aggressive rate cuts (probably far too aggressive), which also helped support bonds.

By the end of September 2008, bond yields were seemingly expensive again, possibly benefiting from a local flight to quality as equity markets were hammered against the global backdrop. Local bonds certainly seemed very out of touch with signals from the rand and EMBI, both of which were very negatively affected as the financial crisis gathered momentum in September and

early October. There is perhaps a mitigating factor – even with the sharp fall in the rand that we have seen over the past few weeks, the fall in commodities has offset that. For example, even after the petrol price reduction in early October, there is still an over-recovery recorded at time of writing. The inflationary implications of the rand's fall this time are being offset (so far anyway) by declines in commodity prices (including food prices). At the moment we still expect to see interest rate cuts from the second quarter of next year. However, the fact that bonds have run so far despite the increase in risk does make us cautious on the near-term outlook.

BONDS DEFY THE RAND



Thus, while we have been saying for some time that bonds offer value on a long-term basis, the sharp moves over the quarter have, in our opinion, more than priced that in now; particularly as we do not feel that the market is adequately pricing in the short-term risks. Indeed, on shorter-term measures bonds are now looking overvalued, and we still do not have much clarity as to whether some of these 'shorter-term' factors (such as the current increase in risk spreads) will in fact become more medium-term ones. The portfolios are thus currently positioned somewhat short vs the ALBI. 

Why property?

by ANTON DE GOEDE

With listed property delivering returns close to 30% per annum over the last five years (outperforming the broader equity market), many investors based their investment decision purely on the capital return potential of the asset class. As a result, little or no consideration was given to the increased risks associated with the higher returns, or the return volatility in excess of the broader equity market.

Property, be it listed or direct, remains mainly an income-yielding asset and therefore fits well as part of a multi-asset class portfolio. Listed property yields tend to track long bond yields and are exposed to macroeconomic variables which could impact interest rates. In the past months alone, inflationary risks and interest rate increases negatively impacted all interest rate sensitive asset classes. The listed property sell-off of 38% in price levels from the high in November 2007 to early July 2008 was even worse than the 26% sell-off experienced in mid-2006 – the start of the current interest rate upcycle.

In an attempt to unpack listed property returns, one could refer to bond market movements as the beta (market return) component and the alpha (outperformance) component as the growth in the underlying income and thus distributions which are paid to investors. For the quarter ended September 2008, listed property delivered a total return of 23.08% as both these underlying return drivers worked in favour of the asset class.

The reasons for this are that market sentiment turned positive on the interest rate front with bond yields following suit. In addition, more than two thirds of the sector in market capitalisation reported during the August 2008 earning season and strong distribution growth of (on average) 11% – 12% came through, with guidance of double digit growth to continue in the short to medium term. Many listed property companies have been relatively sheltered against interest rate increases and thus higher debt servicing costs in their own income statements due to favourable fixed debt profiles. For this distribution growth underpin to stay intact, which is important for current valuation levels, the current low vacancy levels need to remain.



ANTON DE GOEDE is a member of the Absolute Investments team, with specific responsibility for listed property-related research. He has 10 years' investment experience and co-manages the Coronation Property Equity Fund.

The recently released results still point to strong demand for commercial property space in South Africa. The resultant low vacancy rates are leading to upward renewals in rental levels once leases come to the end of their contractual term. Renewal increases of as high as 30% are being achieved in the current environment, specifically those within the office and industrial sectors. Reasons for the current low vacancies include:

- High building costs, leading to high feasibility rentals, which make speculative development less likely
- Funding costs, specifically for speculative developers, have caused development margins to come under severe pressure
- The few years of above 4% GDP growth has led to an increase in demand due to an increase in economic activity across all sectors
- Re-zoning of land has become increasingly difficult, with, if granted permission, waiting periods increasing from a few months to 18 months

This capacity strain in the construction sector, be it from a skill or funding level, is beneficial for landlords as the value unlock in lease renewals in the office and industrial sectors continues to provide a revenue kicker above operating cost inflation.

The decrease in debt to household income ratio in the second quarter of the year, from 78.2% to 76.7%, is promising and the first since a small 0.6% decrease in 2003. Although debt servicing levels increased marginally to 12%, slowing debt accumulation and double digit wage increases, should be encouraging for forward looking retail spend, leading to the proven attractiveness of defensive retail assets in the current economic environment. Super regional and regional shopping malls have produced good results. In a challenging consumer spend environment consumers tend to do more comparative shopping, thus the location of a mall becomes extremely important, offering the combination of a destination and convenience shopping experience.

Although the relative value proposition against other asset classes has reduced in recent months, long-term value in the listed property sector prevails as the sector average forward yield is above that of long bond yields. It is in this forward yield value unlock that listed property remains important in a multi-asset class portfolio. The income stream is growing as underlying property leases are linked to escalation rates in annual rentals and these are closely aligned with inflation trends. It further offers risk diversification benefits as the underlying income is spread between retail, office and industrial properties – each trading in its own investment cycle. Risk is further spread

between properties being located in different metropolitan areas, mixed tenants and staggered lease expiries.

Despite the SA Reserve Bank's recent decision to keep the repo rate unchanged, short-term risks still prevail, most of them linked to the macroeconomic environment. On the one hand these risks include a prolonged higher interest and inflation rate environment with a potential negative impact on bond yields and, on the other hand, a downturn in both the investment and occupier markets of commercial property in line with what has been happening on a global level. 

SABMiller

A portfolio of incredible global brands

by DIRK KOTZÉ

My mate Kobus and I had our first publicly illegal beer in December of 1978, under the shade of palm fronds at the Da Gama Hotel, overlooking Melkbaai beach in the Strand. Needless to say, it was a hot day. I was all of 15; he 14. As a good rites of passage moment should, it passed in languid anonymity, just us, the hot sun, and a couple of pints of Carling Black Label. By partaking of this time-tried custom, we quietly asserted ourselves as adults and as men, deciding when and where to have a drink.

With the benefit of three decades of hindsight, I now thankfully know there are other ways to assert oneself. Age and perspective have also since revealed that what we were doing was by no means unique; like thousands and millions of other young men we were simply reacting to carefully crafted branding cues laid out for us by our friendly local brewing company. If you're a youngster wanting to feel strong and manly, have a Black Label. If you feel a proudly South African moment coming on, go for the taste that's stood the test of time. And if you're a nouveau-riche poser trying to look successful, have a Peroni Nastro Azurro, pronouncing Azurro as if there's a 't' in it.



DIRK KOTZÉ has considerable experience as both equity analyst and portfolio manager. Among the variety of companies and sectors he has researched over the years, his particular interest is cyclical and heavy industrial businesses. Dirk co-manages the Coronation Industrial Fund.

Like bread and milk, beer is a consumer staple. Its appeal is universal and its consumption not particularly affected by incomes or the economy. The result is that beer companies tend to generate stable, sustainable cash flows, 'high quality' in the language of the investment fraternity. We investors are willing to place an above-average rating on such earnings streams; we value beer companies highly.

Coronation has held reasonable weightings of SABMiller shares in client portfolios for some time. Now a truly multinational business, SABMiller escaped the confines of the South African economy in the early 1990s. It sells beer on all continents (even in Australia) with South Africa now representing less than a quarter of the business. At over US\$30 billion market cap, it is a big company. For a South African investor, the diversity offered by exposure to approximately 50 countries and 30 currencies is attractive. Other portfolio holdings that offer this kind of scale and diversity are Richemont, Naspers and MTN. But SABMiller also has unique attractions. Let's run through a few of these.

SABMiller has 80% of its business in emerging markets. In developed markets, people can afford to drink as much as they like. In emerging ones, they tend to drink as much as they can afford. As incomes rise in the southern half of the globe, people will drink more. Beer consumption is also not as universal as we might think. In Russia, most people drink vodka; in China they drink sochu, a rice-based spirit; in Latin America aquadiente, a fire-water made from sugar cane. In all these societies, beer is gaining market share from spirits as people adopt a Western style of living and appreciate beer's refreshment and nutritional properties. Importantly, beer offers a brand experience that cheap spirits cannot: the consumer can make a statement about being manly, being a true patriot or being trendy, all while getting sloshed. All this makes for above-average growth rates for beer companies relative to other consumer staple plays.


The attractions of the industry have not been lost on other participants. In round upon round of corporate deal-making, the industry has consolidated significantly. Most recently Inbev succeeded with the US\$46 billion acquisition of Anheuser Busch, creating the world's biggest brewer. SABMiller is in no. 2 spot, ahead of Heineken and Carlsberg. This concentration should eventually lead to a less competitive industry, with the global majors meeting one or more of 'the usual suspects' in every global market. Over time, this must translate to increased pricing power and profitability.

While growth and consolidation continued in the background, some disquieting developments have come to the fore. Global inflation in food and oil prices affected the brewers badly. Higher prices of barley, glass, plastics and diesel meant brewers had to push their selling prices up in order to maintain margins. At the same time, consumers felt their disposable income affected by the higher food and fuel costs and rising interest rates. Cash-strapped consumers, especially those in price-sensitive emerging markets, reacted negatively to the higher selling prices, and sales volumes suffered more than expected. Brewing companies reported disappointing earnings and volume numbers, and their share prices came under pressure. Into this weakness we increased our exposure to SABMiller. It is now a significant holding and a portfolio differentiator for Coronation.

Of course expectations for the market as a whole and for the world economy have been lowered. But we believe that emerging market economies will continue to beat developed ones on the growth front. Importantly, the factors that caused the disappointment in brewers' earnings are without exception of a once-off or cyclical nature, and are already turning. There are strong indications that

the spike in food and oil prices is behind us, that inflation has seen its peak and that interest rates will be cut going into 2009. Emerging market consumers will rebound pretty soon.

The structural drivers remain in place. What gives us the most comfort in the long-term outlook for the group is the strong emphasis on brands and brand building. This provides loyalty and sustainability to product demand even in tough times. Over time it allows for more pricing power, as consumers pay for their association with desirable brand images. SAB's strength has indeed been the crafting of local brands in whatever market they operate. As you read this, in a faraway country millions of chaps in conical hats are sitting down to a beer of unpronounceable Mandarin name, which translates to Snowflake in English. It might not be under a palm tree or at the beach, but the deal is the same as the one Kobus and I signed up for in 1978. Unlike tobacco which kills the customer in the end, beer keeps refreshing.

While SABMiller's shares (and those of its peer group) traded at 18x P/E a year or two ago, one can now buy this company at 13x. For that price you buy global scale, 'dominion over palm and pine', and a portfolio of wonderful worldwide brands. It's not a difficult investment case, really. 



MARKET DATA

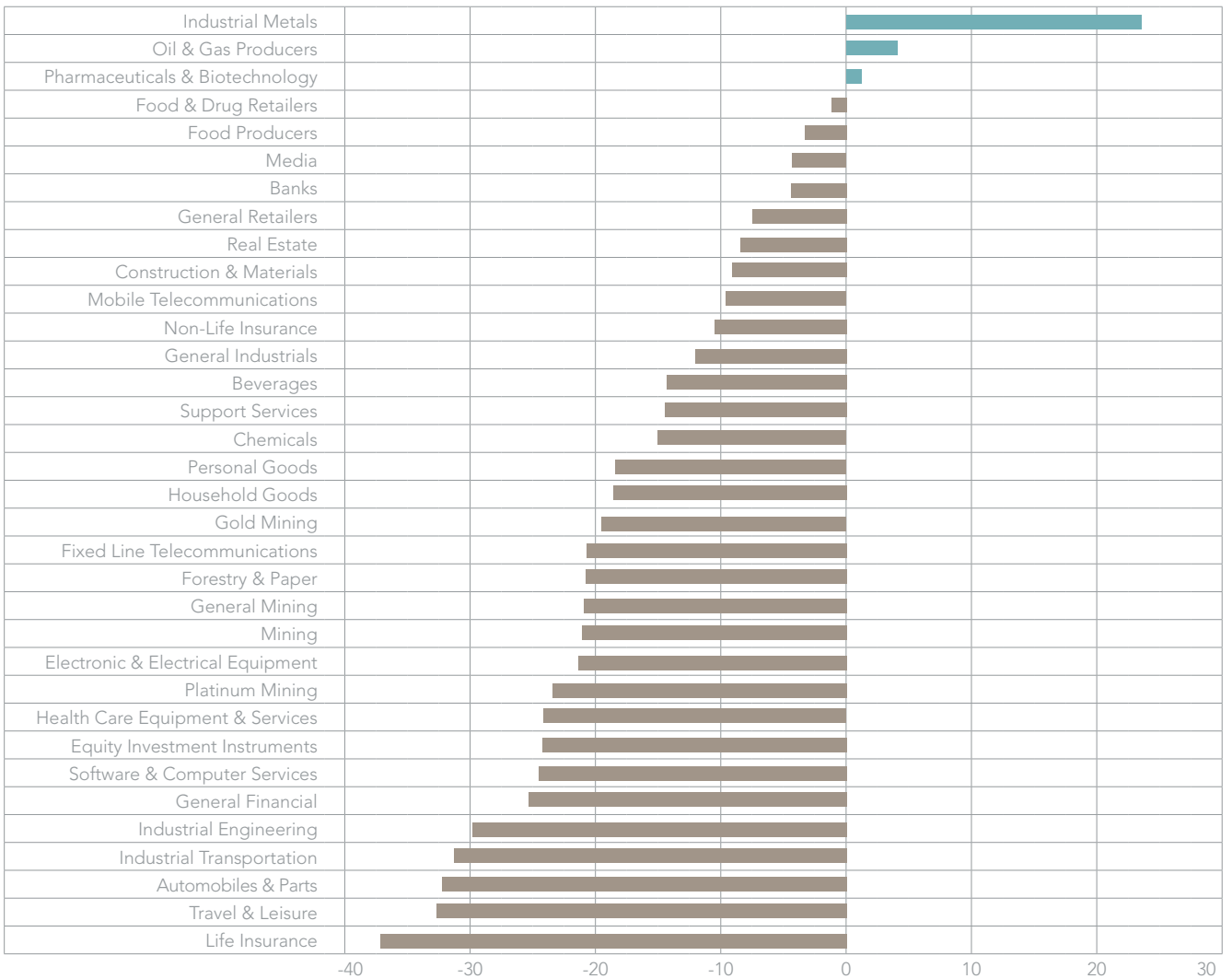
MARKET MOVEMENTS

Economic group	Qtr 3 2008 %	2008 %
All Share Index R	(20.6)	(15.5)
All Share Index \$	(24.5)	(30.1)
All Bond R	12.6	5.1
All Bond \$	6.9	(13.2)
Cash R	3.07	9.08
Resources Index R	(38.3)	(17.8)
Financial Index R	11.9	(16.6)
Industrial Index R	(4.0)	(12.5)
MSCI World \$	(15.2)	(23.8)
S&P 500 \$	(8.4)	(19.3)
Nasdaq \$	(11.9)	(23.1)
MSCI Pacific \$	(20.0)	(25.9)
Dow Jones EURO Stoxx 50 \$	(18.9)	(31.7)

KEY ECONOMIC DATA

	2005a %	2006a %	2007a %	2008f %	2009f %
HCE	6.9	8.2	7.0	3.2	3.3
GCE	4.8	5.2	5.0	4.7	5.5
GFCF	8.9	13.8	14.8	11.3	10.0
GDP	5.0	5.4	5.1	3.7	4.1
Current a/c of GDP	(4.0)	(6.5)	(7.3)	(6.7)	(6.2)
CPIX average	3.9	4.6	6.5	11.5	7.3
Prime rate (year-end)	10.5	12.5	14.5	15.5	14.0

JSE YTD PERFORMANCE



Is this a remake of the 1929 movie?

Despite some similarities between now and 1929, one thing is certain – the authorities will not make the same mistakes again

By TONY GIBSON

Investors and central banks are watching with horror the meltdown of the global financial markets and the disappearance of iconic names that have ruled the financial world for decades. Equity and credit market behaviour is indicating deleveraging of massive proportion and of a totally indiscriminate nature. Some context as to the proportion of the current deleveraging was the development of the hedge fund industry from around US\$300 billion in 2000 to US\$2 000 billion in 2007. These assets were in turn often leveraged 10 times by traders. In addition, over this period there was an explosion of private equity funds, again with leverage of 10 to 20 times. These operations, and the huge leverage taken on by both US households and the US banking system, created a terrifying situation of potential illiquidity in asset markets. This excess leverage of assets was predicated on the belief that the value of these assets could only go up; but this was not to be. Consequently, US households and financial institutions now find themselves in a situation of negative net equity.

The impact of this deleveraging phenomenon is destroying wealth of massive proportion for investors. Pension funds and insurance companies, in particular, are finding themselves with losses which are incompatible with their long-term yield obligations. The problem now is that central banks can inject as much liquidity as they possibly can and lower the cost of borrowing, but it is not sufficient to eliminate the backlog of unsold homes or liquidate the huge amounts of illiquid and non-performing financial products accumulated on the balance sheets of banks. This in turn has led to the necessary but flawed \$700 billion rescue package finally approved by congress in early October. In all likelihood this will not be a magic cure, as



TONY GIBSON is a founder member of Coronation and a former CIO. He was responsible for establishing Coronation's international business in the mid 1990s, and has managed the Coronation Global Equity Alternative Strategy Fund since launch in 1996.

the current crisis is not cyclical but structural. What the world is experiencing is a severe credit crunch following years of massive build-up of leverage and debt at every level of the US and European economies. This was in turn the consequence of a major policy mistake engineered by Alan Greenspan (former US Fed Chairman) in 1998 and pursued between 2001 and 2004. In exactly the same way as one can criticise the stubbornly narrow mandate of the European central bank to focus solely on inflation – a legacy of the German experience of hyperinflation in the 1930s – the Fed's disregard of asset inflation as an indicator of inflationary tensions was wrong in an economy where borrowing money had become a lifestyle.

At times like this it is hard for investors to grope their way through the obscurity of the all-enveloping macro traumas. It is only arrogance or stupidity that would encourage anyone to offer a clear, unambiguous prognostication as to the likely course that the financial markets will take over the coming months. The easy option therefore would be to write a very lucid commentary on the state of the global financial system, summarising the events that have unfolded over the past year. This 'rearview mirror' option is after all not subject to much risk of lack of clarity or confusion. In contrast, attempting to shed some light on the future at present is fraught with uncertainty; and never more so than at any other time since my career in the investment industry began in the late 1970s.

During the past 30 years we have experienced the Latin American crisis of the early 1980s, the 1987 crash, the Savings and Loan crisis of the late 1980s, the Asian crisis of 1997, the LTCM debacle of 1998, and then the bursting of the tech bubble in 2001. Many people are now calling the 2008 crisis the worst financial crisis the world has ever seen, and by implication including the 1929 crisis. It is certainly true to say

that, to make some sense of current events, one really needs to seek illumination from the history books. The first of which is the most recent banking crisis in Japan.

It would seem that the US banking system is now experiencing what Japan experienced in the 1990s – with the caveat that the US situation is more precarious as the starting point for the crisis. In the US, consumers have a negative savings ratio whereas the high savings ratios of Japanese consumers acted as a buffer in the hard landing of the 1990s. A recent broker research report on the Japanese banking crisis makes the following points:

‘The global credit crisis has different causes and features, but we believe that there are lessons to be learnt from the Japanese experience. The key ones are:

- Post-bubble financial crises are always crises of solvency. The only remedy is more capital.
- The first phase of the Japanese crisis – bubble collapse – was followed by a complex, drawn-out secondary phase in which weakness in the real economy led to further market trouble, which in turn fed through the financial system back to the real economy and so on. To have a hope of breaking this kind of negative feedback loop, macroeconomic policy needs to be intensely stimulatory. Japan’s was not.
- Deleveraging is always deflationary. Real interest rates need to be negative from an early stage.
- Fiscal policy has huge room for manoeuvre and deficits are necessary.
- Quick reactions are necessary, unlike Japan which dawdled for six years.
- In systemic crises, forget about moral hazard. If equity and management of institutions need to be destroyed in order to protect creditors (other banks) so be it.’

It would appear that the US authorities are certainly taking heed of these lessons from Japan and are acting timeously. The conclusion would therefore be that, while the US is acting quickly in its responses, it is really only the flux of time that can slowly restore the necessary confidence to financial markets.

As mentioned, the last time that the global financial system experienced something as fundamentally unsettling as the present, was in the 1930s. All other subsequent periodic

market traumas, while painful at the time, never really called into question the stability and functioning of global financial markets. Is it therefore appropriate to draw our conclusions from the years that followed the 1929 experience? Also, is it appropriate to categorise what is currently unfolding as a ‘crash’ similar to that experienced in October 1987? The argument against these two comparisons is that these market falls were of much larger daily magnitudes than at present, and were generated by the stock market itself, with shares trading at unjustifiable multiples. In both 1929 and 1987 the US equity market had gained more than 50% in the preceding 12 months. Today is different. At the peak a year ago, stocks were overvalued, but at nothing like the extremes of 1929. In addition, stocks have been falling for almost one year already.

The problem today is related to credit and housing bubbles – not share valuations. In another sense the ‘crashes’ of 1929 and 1987 were quite different. After 1929, those buying immediately after the sharp falls would have lost almost 80% over the following three years. After 1987, the gains over the following five years were around 50%.

In many ways investors looking for illumination from history will learn more from the years following the bursting of the tech bubble in 2001. In both 2001 and 2008 we find ourselves in financial markets hamstrung by major structural fault lines caused by a misdirected use of capital – induced by a cost of capital that was way too low. In 2001 there was a wild frenzy by the corporate sector to ‘stake a claim’ in the wonderful world of ‘tech, media and telecoms’. Irrespective of the capital costs, many companies felt the need to enter the e-commerce era at any price. Telcos were no longer seen as utilities (which they are) but the gatekeepers into the exciting world of modern communications. Fortunes were spent in acquiring these telcos and, in turn, the 3G licences from their governments. The result was that the corporate sector’s finances got into terrible shape due to this spending and acquisition binge. When the tech bubble burst the reality sank in that the world had completely over-exaggerated the commercial potential to be gained from the ‘TMT’ industries. Also, the reality of severely overstretched corporate balance sheets set in. The period that followed was a number of years of painful restructuring by the corporate sector of their balance sheets, which had become way over-leveraged and exposed to severely impaired or worthless investments.

The difference between 2001 and 2008 is that in 2001 the solvency problems lay in the balance sheets of the corporate sector; and more specifically those in the technology, media and telecom sectors. In 2008 the problems are similar in nature – except that they sit squarely in the balance sheets of individual consumers in the Anglo-Saxon world, and the financial institutions of those countries. While the consequences to the workings of credit markets are undoubtedly more serious today than in 2001, the core consequence is in all likelihood the same. These are as follows:

- Bubbles are inevitably followed by extended multi-year periods of often painful restructuring. This was the case following 2001, and will be so in 2008 and the next couple of years. This was not the case in 1987.
- This restructuring will see the end of unbridled free unregulated financial markets that continued in the post-Thatcher/Reagan era, as all efforts are made to avoid a repeat of the credit bubble.
- Despite some similarities between now and 1929, one thing is certain – the authorities will not make the same mistakes as those made in 1929, and more recently in Japan. The US financial authorities are acting decisively. A global depression is most unlikely.
- Financial calm and sanity will return to financial markets, although fear is high at present. The mere fact that, despite the current turmoil, shares like Citigroup and Wells Fargo are today trading above their June 2008 lows, suggests that investors have retained an element of rationality. In other words, as in the case of Berkshire Hathaway, investors are confident to invest in a share if they perceive it to be financially secure.
- The next couple of years will be tough in terms of global economic activity and investor confidence as savings are rebuilt. Only the flux of time – assuming sensible government policies – can achieve this.
- Inflation will be a non-factor for the next couple of years as the current deflationary forces are combated. However, it should be noted that herein could lie the roots of the next financial crisis. More severe inflationary pressures could be unleashed in years to come following the massive liquidity injections being undertaken at present as the financial system is re-liquefied. On a secular basis, the era of disinflation which commenced in 1982 is probably over.
- There will be ample opportunity to make very attractive returns from equity market investments over this period of restructuring as valuations look extremely attractive, even assuming tough economic times ahead. 🏠

The global managed funds industry

Relatively resilient in extraordinary times

by PIETER KOEKEMOER

The ongoing credit crisis over the past weeks has become, without a doubt, the defining general news story of 2008. Its causes, sequence of events and implications are discussed at length elsewhere in this issue of *Corospondent*. But it is not only a story about the macroeconomic outlook, fiscal policy and deleveraging – it is also about how incredibly widespread the impact of market events and capitalism has become.

You may wonder what more than 300 million people across the world, including 80 million Americans, 120 million Chinese and 3 million South Africans have in common. All have a direct stake in the health of the financial markets as investors in collective investment schemes (unit trusts). And all of them have in some way been affected by recent market events.

Some of the implications of the market crisis for funds and their investors were discussed at a recent international industry conference*, and are highlighted below.

The scope of the crisis is truly global

Share prices and currency exchange rates were impacted everywhere, regardless of the fundamentals of the local economy or the strength of the domestic banking system. Whether you live in Shanghai, San Diego, Stockholm, Seoul, Sydney or Sandton, your share market lost more than 30% of last year's peak values (and in some cases more than 60%). Global market declines of the past weeks have largely been caused by, in particular, US investors reducing risk in their portfolios. The impact of this risk aversion is so significant due to the sheer size of the US: Since 2003, nearly US\$500 billion net new investments were made into foreign markets through regulated mutual funds alone. As much of these assets have been repatriated at speed in late September and early October, asset prices everywhere have come under pressure.



PIETER KOEKEMOER is head of the personal investments business. His key responsibility is to ensure exceptional client service through a combination of appropriate product, relevant market information and, above all, strong investment performance.

It may be the worst financial crisis since the Great Depression, but it doesn't mean that its long-term implications will be as severe

Most observers confirm that the response from global governments has been unprecedented in terms of speed, size, breadth and resilience. Policy makers around the world have shown that they are willing to do whatever it takes to get the financial system back to normal. While the market has not yet sent clear signals that the worst is over, it is possible that confidence in the banking system may be restored relatively quickly.

Investors are still prepared to wait for the long-term recovery... for now

Investor behaviour through the current crisis appears to be more long-term focused, with less withdrawals from growth funds recorded than in previous market crises. This may partly be the result of an increased use of balanced and flexible funds, where the fund manager explicitly aims to meet specific investor-oriented objectives. If this behaviour persists, it may reduce the impact of the crisis on household wealth significantly.

Studies show that investors are more likely to 'convert' the full market return over time if they do not attempt to time their allocations to different assets or managers. The results of one study conducted by Morningstar provide support for this position, see below:

	Investor return	Fund return	Conversion ratio
Equity Sector Funds	6.75%	9.53%	71% 'success'
Balanced Funds	7.88%	7.80%	101% 'success'

Source: Morningstar, *Investment returns in US Mutual Funds, 2003–2007*. Note that the investor return can also be defined as the time-weighted return of the funds, while the fund return refers to the money-weighted return.

Note that the average investor in a balanced fund, following a buy-and-hold strategy, performed significantly better than the average investor in equity sector funds, following a market-timing strategy. The impact of ongoing uncertainty and current double-digit negative returns from moderate risk funds, experienced for the first time in a decade, may however pose a severe test of investor resolve. It will also be interesting to watch whether the relentless global march to convert the retirement system to market-linked defined-contribution schemes continues post the crisis.

Money market funds survived with their integrity largely intact

Regulated money market funds are the lowest risk investment options offered by fund managers. Because these funds can only invest in the highest rated short-term debt instruments, regulators allow managers to price these funds at a stable one rand price, implying capital stability.

With the exception of a few isolated problems in the US and Europe, affecting only five out of approximately 10 000 portfolios, money market funds across the world survived the turmoil of the last few weeks without suffering capital losses. Given the severity of the crisis, the limited impact confirms their safe haven status. Since the introduction of local money market funds a decade ago, no South African investors have suffered capital losses and none are expected at present.

What happened with US money market funds?

US money market funds, with US\$3.5 trillion assets (25% of US GDP), are central to recent credit market events. During 2007, more than US\$1 trillion of new money was invested in these funds, mostly by companies. By the end of June this year, nearly a third of all short-term corporate assets, and 20% of all short-term household assets were invested in money market funds. As a result of their size, these funds became massive providers of funding to corporate America, with more than 40% of commercial paper, 25% of stockbroker repurchase agreements and 25% of local government funding provided by these funds. When Lehman Brothers went bankrupt in September, two US money market funds announced that they 'broke the buck', meaning that they made small losses. This caused an institutional investor panic, with more than US\$300 billion moving out of corporate paper into US government paper in less than two weeks. As a result, the commercial paper market froze up completely, exacerbating the credit crisis. Europe experienced similar events, with more than 10% of the €500 billion regulated money market assets redeemed in the past weeks.

Not all income funds were created equal

Investors were, until recently, happy to take on significant additional risk in exchange for marginal additional benefit. This led to the proliferation of enhanced cash and managed income funds globally. Many of these funds invested in increasingly exotic instruments in an attempt to improve yields and as a result suffered losses when the markets turned. As investors became more risk averse over the past months, these funds experienced massive withdrawals. This again highlights the significant amount of due diligence work that should be performed before deciding that a certain risk profile is acceptable. The old adage still holds true: If you do not understand it, you should not buy it.

Beware perceived safe havens and weak guarantees


Many investors suffered big losses after investing in 'guaranteed' products that proved to be less than secure. During September, Asian investors lost more than US\$10 billion in this way, after buying structured products sold and backed by Lehman Brothers. Remember that a guarantee is only as good as the name behind it, and that unregulated or 'over the counter' investments introduce additional (non-market) risks.

The valuation of assets is also of key concern at the moment. Listed assets respond immediately to market sentiment. In a time of crisis, when fear is the dominant emotion, volatility can be extreme. In this environment, it is best to remember Benjamin Graham's advice: 'The market is a voting machine, not a weighing machine.' It tells you how popular certain investments are, rather than what they're worth. Unlisted assets with similar characteristics to their listed counterparts may appear to provide a smoother return, but this is arguably only due to the availability of less information. A classic example of perceived difference in volatility is found in property investments, with reported returns for listed real estate appearing to be more volatile than for physical property, despite the same fundamentals driving the outlook for both.

Stewardship trumps salesmanship

Investors and their advisors are increasingly emphasising integrity as a key buying criterion. The culture, compensation and incentive structures, governance policies and customer-focus of investment managers will in the post-crisis world become an even bigger driver in manager selection processes. Investors will progressively seek the combination of competence and credibility in a trust-starved world.



While writing about current events which are still in the process of unfolding is a little like identifying the man of the match before half-time, it appears that the investment fund model remains the most resilient, best governed, most transparent and operationally robust vehicle to provide broad-based access to the financial markets. 

** Excerpts from presentations and discussions at the 22nd annual conference of the International Investment Funds Association (IIFA), held in early October in Montreal, Canada. The IIFA represents the global investment management industry. Thirty six industry associations from every continent, collectively responsible for more than US\$24 trillion investment fund assets participate in its activities.*

PERSONAL INVESTMENTS

Personal Investments Update

Increase in offshore exposure of Coronation unit trust and retirement funds

The Minister of Finance announced in the 2008 Budget speech that the percentage of assets that retirement funds may invest offshore will increase to 20%. As a result the offshore exposure limits of the Coronation prudential unit trust funds and individual retirement funds have changed as follows:


Retirement Annuity and Preservation funds

Members of the Coronation retirement annuity and preservation funds may now increase their foreign exposure from 15% to 20%.

Coronation prudential unit trust funds

Coronation has increased the foreign exposure limit on all prudential unit trust funds to 20% with immediate effect. Depending on market conditions the funds may increase their holdings in foreign assets up to the new limit. The funds to which the new limit applies are:

- Coronation Balanced Plus
- Coronation Capital Plus
- Coronation Dynamic Protector
- Coronation Balanced Defensive

Please contact Coronation Client Services on 0800 22 11 77, should you wish to discuss a matter related to this issue. 

Coronation Balanced Defensive

A fund which balances a reasonable level of income with long-term protection of retirement capital

by CHARLES DE KOCK

To match the needs of investors with a low tolerance for the volatility of returns associated with equity investing, the Coronation Balanced Defensive fund was launched in February 2007. The fund aims to beat cash by 3% per year over rolling three-year periods and to achieve this without showing negative returns over any one year. Clients who invest in this fund do not want the rollercoaster type of excitement which pure equity funds deliver. Rather, they want a steady, much less bumpy ride. In order to achieve the cash plus 3% target, some exposure to growth assets is however needed and the price behaviour of the fund is therefore likely to show more volatility than a lower-risk cash-type product.

We could not have wished for a more difficult environment to test the fund's defensive qualities than the turbulent times experienced since its debut 18 months ago. While the fund did not beat cash over this period, its returns have stayed positive throughout.

The list of unfavourable events with which the fund has had to contend reads like a horror story for financial markets – the massive surge in commodity prices, notably oil and food, which has led to far higher inflation than anticipated; a tighter than expected monetary policy; Eskom's power debacle which led to losses of production output and the consequential loss in business and consumer confidence; the ongoing political uncertainty which has impacted the rand and the markets; and, of course, the massive global credit crisis which has led to many high profile casualties.




CHARLES DE KOCK is a senior portfolio manager with more than 20 years' investment experience. He plays a leadership role in the asset allocation process and is responsible for the management of a number of client portfolios. Charles co-manages the Coronation Balanced Defensive Fund.

The fund has been managed in a very conservative fashion at both asset allocation level and the selection of instruments within asset categories. At the asset allocation level the fund's mandate allows it to invest up to a maximum of 40% in equities. We have stayed well below this level largely due to the uncertainty over the full extent of the global financial crisis. We will take our equity holding higher only once we feel the downside risks are lower. Valuations have improved to attractive levels in many cases and we have recently added to our equity exposure but remain below 30% of total fund.

Within equities we have had very low exposure to the more unpredictable resources part of the market. We have instead favoured companies that display an ability to generate healthy cash flows and pay dividends despite the difficult times.

In the interest-bearing area we have favoured cash over bonds but did trade bonds successfully on a few occasions when conditions were favourable. We also held US bonds briefly when those traded at attractive yields – a position we closed out again at a profit.

A main feature of the portfolio is its large exposure to preference shares. We introduced these assets into the portfolio in a meaningful quantity during the second quarter of 2008 at a very attractive tax-free yield. This holding has, since its introduction, reduced the volatility of the fund.

Looking forward, the unfolding of the global credit crisis will have the greatest impact on the world's financial markets over the next year. Locally some favourable news is likely to come as inflation is expected to fall sharply, thereby giving the Reserve Bank the opportunity to ease interest rates. 



REALISE YOUR INVESTMENT POTENTIAL

The most remarkable results start with the smallest of actions. Speak to your financial advisor, visit coronation.com or call 0800 22 11 77 to find out more about our range of unit trust funds and individual retirement products.

CORONATION 
FUND MANAGERS
Investment Excellence



PERFORMANCE TABLES

FUND	LAUNCH DATE	1 YEAR	3 YEARS	5 YEARS	SINCE LAUNCH	TER
SOUTH AFRICAN COLLECTIVE INVESTMENTS						
DOMESTIC EQUITY FUNDS¹						
Equity	15-Apr-96	▲ (11.94%)	14.58%	▲ 27.24%	▲ 18.12%	1.44%
FTSE/JSE Shareholder Weighted All Share Index		(14.72%)	14.90%	25.51%	12.62%	
Top 20	1-Oct-00	▲ (8.71%)	▲ 17.20%	▲ 29.92%	▲ 24.11%	0.96%
FTSE/JSE Top 40 Index		(17.99%)	15.21%	24.96%	16.96%	inc. performance fee discount of 0.19%
FLEXIBLE FUNDS (MARKET-RELATED BENCHMARKS)¹						
Balanced Plus	15-Apr-96	▲ (4.54%)	▲ 14.98%	▲ 23.57%	▲ 17.08%	1.56%
Composite Benchmark ²		(7.48%)	13.77%	20.96%	14.50%	
Market Plus	2-Jul-01	(7.38%)	13.77%	▲ 23.80%	▲ 20.85%	1.80%
Composite Benchmark + 2% ²		(5.48%)	15.82%	23.15%	18.25%	inc. performance fee of 0.33%
Balanced Defensive	1-Mar-07	6.20%	X	X	7.17%	
Short Term Fixed Interest 3-month + 3%		14.27%	X	X	13.54%	1.96%
FLEXIBLE FUNDS (INFLATION-LINKED BENCHMARKS)¹						
Capital Plus	2-Jul-01	(2.81%)	11.26%	▲ 17.04%	▲ 15.49%	1.76%
CPIX + 4% per annum		17.22%	12.27%	10.63%	10.88%	inc. performance fee of 0.42%
SA Capital Plus	1-Apr-04	(2.27%)	11.55%	X	▲ 16.74%	1.79%
CPIX + 3.5% per annum		16.72%	11.77%	X	10.27%	inc. performance fee of 0.38%
Absolute	2-Dec-02	(10.29%)	11.11%	▲ 20.65%	▲ 19.67%	2.51%
CPIX + 6% per annum		19.22%	14.27%	12.63%	12.35%	inc. performance fee of 1.14%
Optimum Growth	15-Mar-99	(15.37%)	7.78%	▲ 14.51%	▲ 15.05%	1.19%
CPIX + 5% per annum		18.22%	13.27%	11.63%	12.08%	
Dynamic Protector	1-Mar-07	(0.35%)	X	X	3.22%	2.13%
CPIX + 6% per annum		19.22%	X	X	17.94%	
DOMESTIC EQUITY SECTOR FUNDS¹						
Industrial	1-Jul-98	(14.90%)	13.05%	27.11%	▲ 17.83%	1.26%
FTSE/JSE Industrial Index		(11.06%)	15.61%	28.49%	12.64%	
Financial	1-Jul-98	▲ (12.91%)	▲ 9.35%	▲ 23.86%	▲ 11.39%	1.44%
FTSE/JSE Financial Index		(17.24%)	9.24%	23.17%	8.10%	
Resources	1-Oct-99	(16.72%)	▲ 25.39%	▲ 29.69%	▲ 27.97%	1.20%
Domestic Equity – Resources and Basic Ind. Mean		(15.13%)	23.66%	26.46%	26.28%	
Smaller Companies	1-Apr-97	(30.79%)	9.45%	21.24%	13.31%	1.20%
Composite Benchmark ³		(18.07%)	15.72%	26.78%	16.04%	
FIXED INTEREST FUNDS¹						
Strategic Income	2-Jul-01	6.44%	▲ 8.83%	▲ 10.00%	▲ 11.98%	1.14%
BEASSA All Bond Index (1 – 3 years)		8.46%	7.51%	8.03%	9.43%	
Preference Share	2-Oct-06	4.76%	X	X	2.62%	0.72%
Short Term Fixed Interest 3-month Index x 0.60%		6.76%	X	X	6.05%	
Property Equity	20-Nov-00	▲ (9.26%)	14.08%	24.26%	21.43%	1.44%
Domestic AA Flexible Property Mean		(9.61%)	14.83%	25.38%	22.18%	
Bond	1-Aug-97	5.71%	▲ 6.94%	8.65%	13.31%	0.86%
BEASSA All Bond Index		5.98%	6.65%	8.68%	13.51%	
Income	3-Apr-00	▲ 9.28%	▲ 7.54%	7.87%	▲ 10.77%	0.92%
BEASSA All Bond Index (1 – 3 years)		8.46%	7.51%	8.03%	10.25%	
Money Market	1-Oct-99	▲ 11.46%	9.06%	▲ 8.55%	9.71%	0.36%
Short Term Fixed Interest 3-month Index		11.27%	9.08%	8.52%	9.77%	
Cash Plus	1-Jul-05	10.92%	8.55%	X	8.36%	0.68%
Short Term Fixed Interest 3-month Index		11.27%	9.08%	X	8.91%	
ONSHORE INTERNATIONAL FUNDS¹						
International Active Fund of Funds	1-Aug-97	(11.02%)	8.75%	10.11%	▲ 11.54%	2.69%
MSCI World Index (ZAR)		(10.73%)	10.59%	11.62%	8.45%	

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The TER (total expense ratio) 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 June 2008, as well as the performance fee accrued over the 12 months to end June 2008. 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. For further information regarding our fee structure please contact us or visit our website.

▲ denotes outperformance. Figures of one year and less indicate percentage change. Figures of one year and more indicate the annualised growth rate.

1. Figures are quoted from Micropal as at 30 September 2008 for a lump sum investment and are calculated on a NAV-NAV basis with income distributions reinvested.

2. Benchmark for the Balanced Plus and Market Plus funds comprises: 63% Equity (Capped All Share Index), 22% Bonds (All Bond Index), 10% Foreign (60% MSCI Equity gross, 25% JP Morgan Global Bond Index, 15% JP Morgan USD 3-month Treasury Bill) and 5% Cash (Alexander Forbes Short Term Fixed Interest Index)



FUND	LAUNCH DATE	1 YEAR	3 YEARS	5 YEARS	SINCE LAUNCH
PENSION FUNDS⁴					
MARKET-RELATED BENCHMARK PORTFOLIOS					
GLOBAL BALANCED					
Houseview	1-Nov-99	▲ 2.87%	▲ 18.82%	▲ 24.10%	▲ 18.79%
Median of Global Large Manager Watch		(0.18%)	18.64%	23.26%	17.83%
Managed One	1-May-96	▲ 2.45%	▲ 19.24%	▲ 24.30%	▲ 18.76%
Upper Quartile of Global Large Manager Watch		0.46%	18.75%	23.83%	16.14%
Managed Two	1-Apr-00	▲ 2.94%	▲ 20.16%	▲ 25.23%	▲ 19.08%
Composite Benchmark ⁵		1.20%	18.55%	22.01%	14.90%
DOMESTIC BALANCED					
Domestic Houseview	1-Apr-04	▲ 4.04%	▲ 20.45%	X	▲ 25.71%
Median of South African Large Manager Watch		1.49%	19.68%	X	23.84%
SPECIALIST EQUITY					
Core Equity	1-Mar-04	▲ 2.59%	▲ 23.68%	X	▲ 29.28%
FTSE/JSE Shareholder Weighted All Share Index		(1.85%)	22.99%	X	26.97%
Houseview Equity	1-May-00	▲ 0.84%	23.33%	▲ 31.97%	▲ 22.14%
FTSE/JSE Shareholder Weighted All Share Index ⁶		(1.85%)	23.70%	28.76%	18.54%
Aggressive Equity	1-Jan-04	▲ (0.56%)	22.25%	X	▲ 28.00%
FTSE/JSE Shareholder Weighted All Share Index		(1.85%)	23.01%	X	26.98%
SPECIALIST FIXED INTEREST					
Cash Plus	1-Sep-02	▲ 11.37%	▲ 9.11%	▲ 8.88%	▲ 9.77%
Short Term Fixed Interest 3-month Index		11.08%	8.93%	8.50%	9.32%
Flexible Fixed Interest	1-Dec-04	5.92%	▲ 9.42%	X	▲ 9.88%
BEASSA All Bond Index (1 – 3 years)		8.65%	7.09%	X	7.20%
Active Bond	1-Aug-00	▲ 6.26%	▲ 6.77%	▲ 9.38%	▲ 13.29%
BEASSA All Bond Index		5.89%	5.82%	8.73%	12.66%
INFLATION-LINKED BENCHMARK PORTFOLIOS					
Global Absolute	1-Aug-99	1.13%	▲ 16.43%	▲ 21.87%	▲ 19.48%
CPIX + 7% per annum		20.63%	15.24%	13.61%	14.05%
Domestic Absolute	1-Apr-02	3.14%	▲ 17.20%	▲ 22.89%	▲ 21.46%
CPIX + 5% per annum		18.63%	13.24%	11.61%	11.77%
Capital Preserver	1-Oct-05	3.44%	X	X	▲ 14.71%
CPIX + 6% per annum		19.63%	X	X	14.40%
Medical Aid Absolute	1-May-04	5.33%	▲ 15.11%	X	▲ 19.12%
CPI + 4.5% per annum		18.21%	13.05%	X	11.39%
INTERNATIONAL FUNDS⁷					
Global Equity (US\$)	1-Jul-00	(28.72%)	0.64%	▲ 8.05%	▲ 0.97%
MSCI World Index (US\$)		(25.62%)	1.27%	7.86%	(0.17%)
Global Equity (ZAR)	1-Jul-00	(14.45%)	9.90%	▲ 11.82%	▲ 3.40%
MSCI World Index (ZAR)		(10.73%)	10.59%	11.62%	2.23%
Global Equity Alternative Strategy ^{7, 8}					
Global Equity Alternative Strategy (US\$)	1-Aug-96	▲ (12.39%)	1.60%	5.23%	▲ 9.14%
MSCI World Index (US\$)		(25.62%)	1.27%	7.86%	4.98%
50% MSCI World Index + 50% USD Cash (US\$)		(11.76%)	4.39%	6.85%	5.00%
Global Equity Alternative Strategy (ZAR)	1-Aug-96	▲ 5.14%	▲ 10.96%	8.90%	▲ 14.70%
MSCI World Index (ZAR)		(10.73%)	10.59%	11.62%	10.33%
50% MSCI World Index + 50% USD Cash (ZAR)		5.90%	14.00%	10.58%	10.34%
Relative Value (US\$)	1-Jan-00	(9.58%)	2.34%	▲ 3.71%	▲ 5.35%
US T-Bill (US\$)		2.13%	3.81%	3.06%	3.07%
Relative Value (ZAR)	1-Jan-00	8.52%	11.76%	▲ 7.33%	▲ 8.95%
US T-Bill (ZAR)		22.55%	13.36%	6.65%	6.60%
Multi-Strategy (US\$)	1-Aug-02	(4.06%)	3.81%	4.34%	4.14%
LIBOR +3% (US\$)		6.52%	7.70%	6.73%	6.28%
Multi-Strategy Fund (ZAR)	1-Aug-02	15.15%	13.36%	7.98%	0.65%
LIBOR +3% (ZAR)		27.24%	17.34%	10.34%	2.82%
Global Bond (US\$)	2-Jul-03	0.84%	4.44%	▲ 5.39%	▲ 5.51%
Citigroup World Government Bond Index (US\$)		5.90%	5.57%	5.34%	5.34%
Global Bond (ZAR)	2-Jul-03	19.17%	13.47%	8.73%	7.40%
Citigroup World Government Bond Index (ZAR)		27.10%	15.29%	9.01%	7.63%

3. Benchmark for the Smaller Companies fund is a market cap weighted index of the FTSE/JSE Small and Mid Cap Indices.

4. Figures are quoted from the Alexander Forbes Large Manager Wealth Survey as at 31 August 2008.

5. Benchmark for Managed Two comprises 60% Equity (Capped All Share Index), 20% Bonds (All Bond Index), 15% Foreign Equity (MSCI World Index) and 5% Cash (Alexander Forbes Short Term Fixed Interest Index).

6. Benchmark for Houseview Equity changed from FTSE/JSE Capped All Share to the Shareholder Weighted All Share Index on 1 July 2007.

7. Figures quoted as at 30 September 2008, with estimates for fund returns for the period.

8. This fund is available to institutional investors only. An estimate was used for September's fund performance.

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