

The Coronation Bond Fund showed a return of 4.4% over the past quarter, marginally behind the All Bond Index (ALBI) return of 4.7%, and ahead of cash at 1.9%. The fund return for the year to date at 4.7% is still marginally ahead of the ALBI return of 4.3%, and both marginally ahead of cash at 3.8%.

The best performing section of the yield curve for the year to date was the 7-12 year area, which returned 4.9%. However, the star performer in the fixed interest universe this year has been inflation-linked bonds (which are not included in the ALBI). The Barclays SA Inflation-Linked Bond Index returned 9.6% in the year to June, with the long-dated R202 (maturing 2033) returning an impressive 12.1%. Real yields on the bonds have fallen significantly this year (underpinning their price), while breakeven inflation – the implied expected inflation rate calculated by comparing inflation-linked versus nominal bonds – has risen. This appears to be partly due to heightened inflation concerns as the rand weakened during the second quarter. However, the good performance of inflation linkers also appears to be a reflection of a continuing imbalance in the market as demand continues to grow faster than supply. The fund benefited from exposure of around 7% to inflation-linked bonds.

Positive performance from bonds in the second quarter was due to a number of factors. The kick-start, early in the quarter, was another surprise repo rate cut (by 50 basis points to 7.0%) delivered by the Reserve Bank at the April Monetary Policy Committee meeting. This also led to a tandem move down in the R153 of about 50 basis points. The yield curve was also steeper in the second quarter compared to the first, which could be ascribed to a combination of some inflation fears creeping in as the rand weakened, as well as the fact that most of the new supply coming into the market from government is at the longer end of the yield curve. Since the beginning of the current fiscal year in April, about 75% of government auction amounts have been in the 12 years and longer sector of the curve.

The other important factor in keeping yields low despite rand weakness was further downward moves in global bond yields. While the focus is usually on the US, it is also worth noting that German bonds reached record low yields during the quarter. Federal Reserve Chairman Alan Greenspan has described the low bond yields in the US as a "conundrum", and there have been a number of explanations put forward as to why bond yields seem to defy the economic realities in the US – where growth is still reasonably strong and the Fed still raising interest rates. The most appealing explanation appears to be linked to high savings rates in Asia being recycled into purchases of US Treasuries where, although yields are low at just over 4%, they are still well above Japanese 10-year yields of around 1.3%.

We continue to hold our relatively bearish (compared to consensus) views on the rand and inflation over the shorter term. While the movements of the rand in the second quarter were largely in line with our view (albeit materialising a bit sooner than expected) and thus leave our year-end forecast of R/US\$6.95 intact, there are still many market participants expecting a retracement to stronger rand levels. These differing views have different implications for inflation, and we see a good chance of CPIX breaching the upper limit of the 3% - 6% target early next year. As such, we think any further rate cuts are highly unlikely (the FRA market is still discounting a chance of a rate cut later this year) and, indeed, rate rises may happen sooner than the market thinks.

While recent moves in the oil price will certainly help push inflation up, our concerns about inflation stem more broadly from a very robust economy, which no longer has the advantage of a continuously appreciating rand to offset incipient demand-led inflation pressures. These include very robust consumer spending, high growth rates in money supply and credit (household credit is growing well over 20%), and continued pressure on the current account as a result of the strong rand and low interest rates.

We reiterate that our negative view on inflation is a short-term, cyclical view, and that the structural improvement remains in place. But we emphasise that while we believe SA has in general moved into a structurally lower inflation environment, we cannot ignore the fact that inflation will still exhibit cyclical movements.

Another factor that will affect the bond market is supply. While data for the fiscal year so far already show revenue collections that may lead to a reduction in government supply, it remains the case that government supply of bonds will be higher than was the case a few years ago. Moreover, there will be significantly increased parastatal issuance to help fund the announced investment programmes; Eskom has already announced a R5 billion domestic market issue will take place, and other issuers (such as the Trans-Caledon Tunnel Authority) continue to tap the markets. Finally, corporate issuance (including securitisations) is expected to remain strong. It is thus clear that the supply picture has turned from being supportive to being a source of some pressure for the market. This is especially so given that recent fund manager surveys indicate that bonds are the least favoured asset class this year, implying that the demand picture will not be particularly strong.

US yields remain the most important factor in determining SA yields, and thus a continuation of the low yield environment that we have seen will be supportive for SA bonds. While US bond yields have certainly surprised on the low side, we still expect some increase in yields based on economic fundamentals (though the extent will likely be mitigated by continuing capital inflows to the US Treasury market from Asia). Moreover, we expect that the spread between SA and US bonds – which has already widened about 70 basis points since its low in late February – will continue to widen as domestic fundamentals for the bond market, as described above, worsen.

Thus, our overall view remains one of some further weakening in the bond market. With inflation expected to turn upwards, US bond yields to rise further, global risk appetite to reduce, and a higher budget deficit leading to higher supply we expect bond yields to move higher over the course of the year.

On this basis we will be maintaining our stance of an underweight duration to bonds, with a fund modified duration (excluding inflation-linked bonds) of 2.9 years, compared to a modified duration of 5.0 years for the All Bond Index.

**Edwin Schultz**  
Portfolio Manager

# CORONATION BOND FUND

as at 30 June 2005

Fund category	Domestic Fixed Interest Bond
Launch date	1 August 1997
Portfolio manager	Edwin Schultz
Fund size	R164.06 million
NAV	1320.55 cents
Annual management fee	0.75% (ex VAT)

Benchmark	BEASSA ALBI Index
Fund description	Seeks to provide investors with a well-diversified exposure to the SA bond market.

## ASSET ALLOCATION

Maturity Band	30 Jun 2005	31 Mar 2005
0 – 1 year	27.21%	13.31%
1 – 3 years	11.16%	12.00%
3 – 7 years	39.61%	52.79%
7 – 12 years	17.16%	18.11%
12+ years	4.86%	3.79%

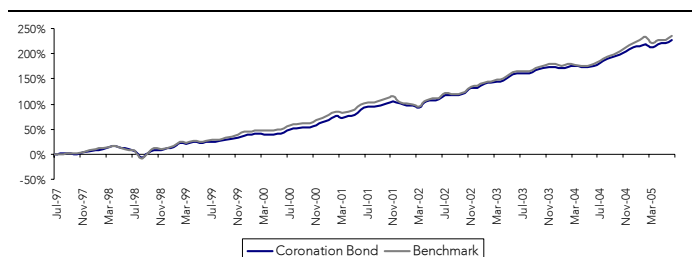
## PERFORMANCE & RISK STATISTICS

	Fund	Benchmark
Year to date	4.72%	4.33%
Latest 12 months	18.20%	20.09%
Latest 36 months (annualised)	16.10%	16.55%
Latest 60 months (annualised)	17.79%	17.21%
Since inception (annualised)	16.12%	16.53%
Annual deviation since inception	8.55%	10.27%
Sharpe ratio	0.49	0.46
Maximum gain	26.21%	26.36%
Maximum drawdown	-19.02%	-22.26%
Positive months	77.89%	75.79%

## ANNUAL RETURNS SINCE INCEPTION

	Fund	Benchmark	Active Return
2004	13.94%	15.25%	-1.31%
2003	17.47%	18.07%	-0.60%
2002	16.32%	15.96%	0.36%
2001	22.36%	17.84%	4.52%
2000	19.43%	19.44%	-0.01%
1999	23.05%	28.73%	-5.68%
1998	5.00%	5.04%	-0.04%
1997	6.08%	7.12%	-1.04%

## CUMULATIVE PERFORMANCE SINCE INCEPTION



## INCOME DISTRIBUTIONS

Declaration	Payment	Amount	Interest
31/03/2005	01/04/2005	59.42	59.42
30/09/2004	01/10/2004	83.29	83.29
31/03/2004	01/04/2004	66.02	66.02
30/09/2003	01/10/2003	83.43	83.43

## MONTHLY PERFORMANCE RETURNS

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
Fund 2005	1.04%	1.38%	-2.11%	2.01%	0.35%	2.02%						
B'mark 2005	1.45%	1.99%	-3.67%	2.06%	-0.12%	2.69%						
Fund 2004	-0.59%	0.88%	0.19%	-0.67%	0.20%	0.95%	1.75%	3.29%	1.19%	1.86%	1.86%	2.29%
B'mark 2004	-1.03%	0.96%	-0.23%	-0.81%	0.14%	1.12%	1.98%	3.51%	1.28%	2.17%	2.25%	3.06%