CORONATION BOND FUND

as at 31 December 2006

CORONATION FUND MANAGERS

Bonds extended their gains into the fourth quarter, with the All-Bond Index (ALBI) up 5.6% for the quarter, to close the year at 5.5%. The Coronation Bond Fund produced a healthy 6.8% return for the year, comfortably outperforming the ALBI. 2006 was a year in which it was not just a matter of getting the duration of the portfolio correct, but crucial to have the fund positioned in the right area of the yield curve - the 12+ area produced a 10% return for the quarter while the 1-3year area returned a mere 2.3%.

2006 saw the end of the easing repo rate cycle and a 2% rise in short rates. Thus the two big questions going forward are whether we will see further increases in interest rates; and how the positive longer term structural argument for bonds will play off against the current challenging cyclical environment.

But before answering these, let's have a brief recap of 2006. Bond yields started in a bullish frame of mind at around 7.50% and very quickly firmed close to 7.00% by mid-February. However, a vicious sell-off in the rand, starting in May on current account deficit fears, saw bonds follow suit as inflation fears surfaced. The 10-year bond sold-off all the way to around 9.00% by September. However, the announcement of the very positive medium-term budget in October, coupled with a stronger US treasury market, saw local bonds rally back to 8.00% by year-end. In a highly volatile year, the All Bond Index produced a return of 5.5%, and the yield curve changed shape rather dramatically to a substantially inverted curve.

On the outlook for interest rates, consumer demand and the current account deficit appear to be the two main factors of concern for the SARB at the moment (as these are seen to pose risks to the inflation outlook).

While consumer demand has so far appeared to show little response to the interest rate rises, we believe that this is largely due to the lag effects and that there are indeed early tentative signs of a slowdown. The combination of rising interest rates and still-increasing consumer debt means that for the first time in this cycle of sharply rising debt, the debt servicing level (interest repayments) have exceeded the levels seen at the top of the 2002 rate hike cycle. While servicing levels are still far below the "crisis" level of 1998 and well below the levels seen throughout most of the 1990s, we do believe they are now high enough for consumers to start "feeling the pinch". This will help slow consumer spending to levels more consistent with the inflation target.

Recent data have seen the SARB revise the current account deficit for the first three quarters of 2006 smaller, recording levels of 6.1%, 5.7% and 5.2% of GDP respectively. While the deficit remains wide, we note that it has narrowed by almost 1% of GDP over this time – a time when the rand was still relatively strong for the first part of the year and when there was yet little impact from the interest rate rises. The expected slowing in consumer demand should be underpinned by the rand's depreciation this year (the currency is still quite weak despite the recent pullback, especially on a trade-weighted basis). This means that the rand is at far more competitive levels than it has been for some time, which should help both subdue imports and promote exports – a combination that should contribute to further narrowing the current account deficit.

One key risk for the current account remains the oil price. Oil is a significant import, and the deterioration in the deficit over the past couple of years is partly due to rising oil prices. So, despite our expectation that consumer demand will slow and the rand will help the deficit, oil does remain a threat.

Of course, what ultimately matters for interest rates is the effect of these factors on inflation. We think inflation may breach the upper end of the target range of 3% - 6%, but only by a small margin and for a short period of time. Thus we don't expect the breach to have a significant bearing on the SARB's actions, and believe that December may have been the last hike in this cycle. However, the risks remain tilted to the upside; any really nasty inflation surprises (possibly due to food or oil prices surprising on the upside), or a lack of meaningful improvement in the consumer spending data, could see the SARB raise rates again in February. Should this happen, we would certainly expect it to be the last rise in the cycle.

Regarding the question on the structural versus cyclical argument for bonds, the medium-term budget indicated that South Africa would, for the first time, move from a fiscal deficit to a fiscal surplus in the 2007/08 fiscal year. This will result in substantially less government bonds being issued in the bond market, with the result that (taking maturing bonds into account) there will be a net buy-back of government debt in 2007.

From an asset allocation perspective local fund managers appear short of bonds in their balanced portfolios, preferring to hold higher yielding money market instruments. Also, bond portfolios will drift shorter from a duration perspective relative to the benchmark as the All Bond Index is reweighted longer in February 2007. All of these factors further underpin the structural shortage of SA government bonds, and this is before the seemingly increasing voracious appetite of foreign investors is taken into consideration. Thus, we expect the demand/supply balance to be a strong support for bonds.

The rising short rates cyclical argument and the structural shortage of bonds is best illustrated by the massive inversion of the yield curve, where one year assets are trading at around 9.70% and 20 year assets at around 7.50%. Our interpretation of this is that the bond market is 'buying' the big picture long term structural story for SA bonds (low inflation after the cyclical blip and lower supply). This is keeping longer-dated yields anchored at lower levels, while short-dated yields are dependent on the repo rate.

Finally, we should not ignore the positive global story, which indeed is also a factor underpinning the better structural story in South Africa. We would note that US 10-year bonds seem unable to sustain moves much above the 4.5% level (which we would consider long-term fair value), and emerging market debt has defied all predictions and (after a blip in May) has continued to show very tight spreads on a historical basis. These factors remain very supportive of SA bonds too, but we should recognise that there is a potential risk to the bond market should this sweet international spot turn sour.

Mark le Roux
Portfolio Manager

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CORONATION BOND FUND

as at 31 December 2006

Fund category	Domestic Fixed Interest Bond
Launch date	1 August 1997
Portfolio manager	Mark le Roux
Fund size	R105.6 million
NAV	1347.82 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	31 Dec 2006
0 – 1 year	5.89%
1 – 3 years	15.95%
3 – 7 years	19.65%
7 – 12 years	36.74%
12+ years	21.78%

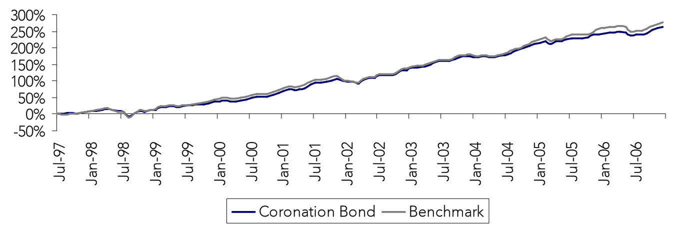
PERFORMANCE AND RISK STATISTICS

	Fund	Benchmark
Year to date	6.76%	5.48%
Latest 12 months	6.76%	5.48%
Latest 36 months (annualised)	10.51%	10.43%
Latest 60 months (annualised)	13.02%	13.02%
Since inception (annualised)	14.89%	15.10%
Annual deviation since inception	8.04%	9.65%
Sharpe ratio	0.41	0.36
Maximum gain	26.21%	26.36%
Maximum drawdown	-19.02%	-22.26%
Positive months	77.88%	76.99%

ANNUAL RETURNS SINCE INCEPTION

	Fund	Benchmark	Active Return
2005	10.96%	10.80%	0.16%
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
30/09/2006	01/10/2006	35.92	35.92
31/03/2006	01/04/2006	50.61	50.61
30/09/2005	01/10/2005	49.05	49.05
31/03/2005	01/04/2005	59.42	59.42

MONTHLY PERFORMANCE RETURNS

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Fund 2006	0.72%	0.93%	-0.26%	1.02%	-0.76%	-2.38%	0.63%	-0.18%	1.43%	3.26%	0.91%	1.34%
B'mark 2006	0.96%	0.78%	-0.23%	1.16%	-1.12%	-3.61%	0.68%	0.04%	1.36%	3.11%	0.86%	1.51%
Fund 2005	1.04%	1.38%	-2.11%	2.01%	0.35%	2.02%	0.62%	0.16%	0.32%	0.70%	2.12%	1.91%
B'mark 2005	1.45%	1.99%	-3.67%	2.06%	-0.12%	2.69%	1.00%	0.02%	0.08%	0.63%	2.37%	1.97%

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