

Into the rate upcycle...

Bonds extended their losses, with the All-Bond Index (ALBI) down 3.6% for the quarter. This brings the year-to-date loss on the ALBI to just over 2%. The defensive, short-duration position maintained in the Coronation Strategic Income Fund against this background proved to be the right move; the benchmark 1 – 3 year bond index declined by 0.28% for the quarter but still managed a positive return for the year to date.

Bonds are the worst-performing asset class so far this year, with their negative performance being trounced by equities: up 4.9% for the quarter, despite the jitters seen in May and June, and still up a smart 18.8% for the year to date. Bonds trailed cash (up 1.8% for the quarter and 3.6% year-to-date) as well as inflation-linked bonds, which were up 0.6% for the quarter and 3.3% for the year so far.

The poor bond performance was led by a number of factors, principally the reduction in risk appetite for emerging market assets that we had expected would eventuate sometime this year. The trigger point seemed to be the US Federal Reserve raising interest rates beyond where many had expected, coupled with expectations of further monetary tightening by both the European Central Bank and the Bank of Japan. Many other central banks, including those of a majority of emerging markets have been in, or have now begun, a tightening mode. Rising interest rates both reduce general liquidity available in the market – usually meaning a fall in risk appetite – and also raise the relative return required by other assets if they are to continue to remain attractive.

Although the JPMorgan Emerging Markets Bond Index (EMBI) has held up quite well, it is weaker than its best levels of earlier in the year. Local bonds were affected by this, but seemingly more so by the fall in the rand that accompanied lower risk appetite. At the time of writing, the trade-weighted rand has lost some 18% since late April. The cherry on top for the bond market was the SA Reserve Bank's (SARB) move to raise the repo rate by 50 basis points to 7.5% at the June Monetary Policy Committee meeting. While the FRA market had discounted some probability of a rate rise, it seemed that the bond market was to a large extent caught unawares by the move. A negative current account number for the first quarter subsequently sent jitters through the market opening the possibility of further rises of the SA repo rate. We have for some time expected that interest rates would enter an upcycle this year and thus were positioned for the market moves.

Given that the weakness in the bond market hadn't yet filtered through to property stocks, we sold down most of our SA property holding. This proved to be the correct move as the property index sold off towards mid-June. We took profits on rand hedge stock Liberty International which rallied to return over 11% for the quarter

While we are not implementing any material adjustments to our inflation forecast in light of recent developments, some factors have deteriorated more than we had expected and thus upside risks remain. At present we expect SARB to raise interest rates another 100 basis points by February 2007.

While inflation-linked bonds have outperformed conventional bonds over the past year, with real yields starting to rise and breakeven inflation rates up at levels that no longer offer value, we have now sold most of our holding. Looking forward, it seems it will be very difficult for inflation linkers to outperform cash.

An interesting development in the domestic market was a change in sentiment towards credit, where the previous "buy at any price" attitude towards new corporate bond issues received a shock when recent issues struggled to find a decent reception in the market. We have for some time believed that credit spreads in general were too tight (i.e. prices did not justify the risks) and that it made sense to be both underweight in credit and hold only high-quality issuer names. Any risk aversion is likely to affect credit spreads, and this is what we saw during the quarter. The pipeline for new non-government issuance (including parastatal issuance) remains quite large. We remain defensive in credit.

While we had been defensively positioned in the run-up to the repo rate hike, we feel that bond yields are closer to fair value. Still, the call between bonds and cash remains a close one over the next 12 months – especially on a risk-adjusted basis. The process of increasing global interest rates is likely to continue for some time, which will continue to bias sentiment against risky assets. Risks for the rand (and consequently inflation) are also thus probably biased to the negative, both from the global background as well as the wide current account deficit. While bonds are not as overvalued as they were at the beginning of this year, we would remain wary of positive gains for a while, especially until it is clearer where and when the domestic monetary tightening cycle will end.

Mark le Roux & Tania Miglietta
Portfolio Managers

Fund category	Domestic Fixed Interest Varied Specialist
Launch date	2 July 2001
Portfolio manager	Mark le Roux & Tania Miglietta
Fund size	R3 billion
NAV	1259.97 cents
Annual management fee	1.00% (ex VAT)

Benchmark	BEASSA ALBI (1 - 3 year) TR Index
Fund description	A widely diversified, actively managed fund that aims to provide a higher level of income than a pure income fund.

ASSET ALLOCATION

Sector	30 Jun 2006
Domestic Assets	100.0%
Cash/Money Market	43.1%
Bonds	40.9%
Listed Property	7.6%
Preference Shares	2.8%
Other investments*	5.6%
International Assets	0.0%

* Makalani Holdings Ltd: High yielding, listed, mezzanine debt and BidBEE

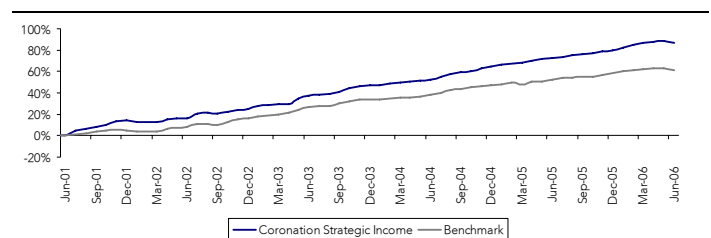
PERFORMANCE AND RISK STATISTICS

	Fund	Benchmark
Year to date	3.72%	1.55%
Latest 12 months	8.75%	5.53%
Latest 36 months (annualised)	11.03%	8.28%
Latest 60 months (annualised)	13.46%	10.02%
Since inception (annualised)	13.46%	10.02%
Annual deviation since inception	3.71%	2.92%
Sharpe ratio	1.00	0.09
Maximum gain	29.19%	15.89%
Maximum drawdown	-1.05%	-1.54%
Positive months	91.67%	85.00%

ANNUAL RETURNS SINCE INCEPTION

	Fund	Benchmark	Active Return
2005	9.85%	7.70%	2.16%
2004	11.88%	10.17%	1.71%
2003	18.09%	15.02%	3.07%
2002	9.58%	11.50%	-1.92%
2001	13.98%	4.34%	9.64%

CUMULATIVE PERFORMANCE SINCE INCEPTION



INCOME DISTRIBUTIONS

Declaration	Payment	Amount	Dividend	Interest
30/06/2006	01/07/2006	16.06	0.21	15.85
31/03/2006	01/04/2006	21.54	2.57	18.97
31/12/2005	01/01/2006	18.44	0.50	17.94
30/09/2005	01/10/2005	15.04	0.04	15.00

MONTHLY PERFORMANCE RETURNS

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
Fund 2006	1.17%	1.61%	0.87%	0.66%	0.42%	-1.05%						
B'mark 2006	0.74%	0.74%	0.35%	0.73%	0.09%	-1.09%						
Fund 2005	0.70%	0.92%	0.26%	0.88%	1.16%	0.76%	0.48%	0.73%	0.68%	0.65%	0.87%	1.35%
B'mark 2005	0.34%	0.96%	-1.05%	1.69%	0.41%	1.25%	0.75%	0.31%	0.18%	0.24%	1.40%	0.99%