

# corospondent

The Coronation Fund Managers Institutional Quarterly



A volatile quarter.

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April 2011

**CORONATION**   
FUND MANAGERS



# Popular uprisings and a natural disaster

How do we invest in a world of nasty surprises?

by **CHARLES DE KOCK**



*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.*

The first quarter of 2011 was marked by two major unpredictable events: a spate of popular uprisings in North Africa and the Middle East and the massive earthquake and tsunami that hit Japan. When unpredictable events of this magnitude occur it impacts the global economy and investment markets.

## It started in Tunisia

In the case of the uprisings taking place in North Africa and the Middle East the major impact on the global economy is through spikes in the oil price. The turmoil started in Tunisia, and quickly spread to Egypt, then on to oil-producing countries including Libya, with a sharp rise in the oil price as a result.

What is going to be crucial worldwide is how long the oil price will stay high. If it is merely a spike and prices are back around \$70 to \$80 a barrel then the normal cycle, which is currently a slow economic recovery, will continue. If, however, oil stays at current levels (\$120 per barrel at the time of writing) it will hinder the recovery and put more upward pressure on prices.

The reaction of the various monetary authorities may well be quite different. In the US the Federal Reserve has in the past treated a spike in the oil price as having the same impact on the consumer as a tax. It leaves the consumer with less money in his pocket. They have therefore tended to keep interest rates low during such times. On the other hand the more inflation-target oriented central banks look at the impact of higher fuel prices on inflation and use it as a reason to hike interest rates. In early April the European Central Bank did act on the inflation fears and raised rates by 25 basis points.

We do not try to guess how long the oil price will stay around current levels, but as our clients well know, our investment approach aims to price assets at normal mid-cycle levels. The oil price is currently above our view of normal and we therefore expect it to recede. The upheaval in the oil-producing nations will come to an end. These countries are extremely dependent on producing and selling oil and any disruption to supply is likely to be temporary. In many cases, changes in regimes from long running dictatorships in favour of more open inclusive governments will occur. But in others the process could include a civil war and even external military intervention, as is the case in Libya.

## The Japan earthquake and tsunami

The natural disaster that hit Japan will also impact the global economy, but it is a far more localised problem. The immediate impact is a large loss of production within Japan as factories have either been damaged or in many cases totally destroyed. It will undoubtedly have a negative impact on Japan's gross domestic product for a number of quarters.

Over the medium term, however, the Japanese state has no choice but to spend and deploy as many resources as possible to cleaning up the disaster area and start the process of rebuilding. Roads, bridges, railroads, ports, factories, power plants, and of course thousands of homes will need to be rebuilt. This process will in time be favourable for many construction firms, cement producers, employment of engineers and others.


## Investment implications

Investors are often faced with surprises. No-one could have foreseen the occurrence of these events. Yet, it is our task as professional asset managers to build portfolios in such a way that they can withstand tsunamis, wars, urban terror or other disasters.

Diversification is the key. A well diversified portfolio has the ability to withstand all kinds of events. And here we speak of diversification of geographies, industries, currencies and asset classes. In our global funds we have exposure to Japan, which is after all the third largest economy in the world. But the exposure was limited to 12.8% in our Global Equity Fund of Funds, 10.1% in Global Opportunities and 3.4% in our Global Equity Alternative Strategy Fund. In South African balanced portfolios where total global exposure is at maximum 25% of total fund, the direct exposure to Japan is therefore no more than about 2% on a see through basis, depending on which fund is used.

The Nikkei at one point had declined by almost 20% following the disaster, and other markets also retreated, but well diversified portfolios were protected as exposure to any one country or industry is limited. The major sell-off in Japanese assets was in fact a good opportunity for us to add to our investments in Japan at cheaper prices.

We have some exposure to Egypt in our Africa funds. The Egyptian stock market has been closed for 40 days and has only opened for limited trading hours on 23 March 2011. This market is down 28% since the start of 2011 but again, in balanced funds, the exposure to Egypt on a see through basis is very small indeed.

In the case of the surging oil price, many consumer businesses will suffer due to higher transportation costs – but we also own companies such as Sasol and BHP Billiton that will reap some benefit from the higher oil price. Again, the point is that in a well diversified portfolio, exposure to different businesses offers protection against unforeseen events. 

## MARKET DATA

### MARKET MOVEMENTS

Economic group	Qtr 1 2011 %	2010 %
All Share Index R	1.1	19.0
All Share Index \$	(0.9)	33.0
All Bond R	(1.6)	15.0
All Bond \$	(3.5)	28.5
Cash R	1.4	6.9
Resources Index R	2.8	12.3
Financial Index R	0.7	16.6
Industrial Index R	(0.3)	27.4
MSCI World \$	4.9	12.3
S&P 500 \$	5.9	15.1
Nasdaq \$	3.6	14.2
MSCI Pacific \$	(2.0)	16.1
Dow Jones EURO Stoxx 50 \$	10.5	(9.1)

### KEY ECONOMIC DATA: HISTORY AND FORECAST

	2007a %	2008a %	2009a %	2010a %	2011f %
HCE	5.5	2.2	(2.0)	4.4	4.8
GCE	4.1	4.7	4.8	4.6	4.5
GFCF	14.0	14.1	(2.2)	(3.7)	2.5
GDP	5.6	3.6	(1.7)	2.8	3.7
Current a/c % of GDP	(7.4)	(7.1)	(4.1)	(2.8)	(4.6)
CPI	7.1	11.5	7.1	4.3	4.9
Prime rate (year-end)	14.5	15.0	10.5	9.0	10.5
R/\$ year-end	6.83	9.92	7.48	6.81	7.75
R/EUR year-end	9.94	13.44	10.89	9.00	9.84



# It's never too early

## Saving for retirement

by **KIRSHNI TOTARAM**



*KIRSHNI TOTARAM heads up the institutional business and is a member of the executive committee. She is a qualified actuary and a former manager of the Coronation Property Equity Fund.*

I am surprised each time I come across people who simply cannot afford to retire at age 65 (and older), and are forced to keep working or are left with small amounts of capital that afford them very little dignity in retirement.

In today's world of instant global communications, the web and the fast pace of change, we have become a consumer generation where instant gratification is a way of life. It is no wonder then, that most of us spend little time thinking of our future, or what will happen when we retire. The possibility of getting old is one that we are simply not prepared to entertain – not even for a second.

Couple these points with the recent financial crisis and the erosion of confidence in the financial system and it is little wonder that the savings culture in most economies has been on a steep decline in recent years.

### The pension and savings landscape in South Africa

In days gone by, most employment took place in the formal sector. Job turnover was low and most people stayed with the same company for most of their careers. The standard pension fund at the time was 'defined benefit' – i.e. there was a value at retirement, determined using a formula of final salary and number of years employed. For many this provided a formal level of saving and a value at retirement that took cognisance of earnings and inflation. But even then it wasn't always enough.

Today, South Africa does not yet have compulsory preservation (i.e. everyone is not required by law to contribute a portion of their salary to a retirement fund or savings vehicle), nor mandatory saving. This means that many people do not even consider saving for retirement until late into their 40s. Further, virtually

all remaining retirement funds within the formal sector are no longer 'defined benefit' in nature, but 'defined contribution'. This means that there is no pre-determined benefit at retirement and the employee has the option to cash in his/her investment should there be a change in employment. Regrettably, most people choose this option, using the cash to finance a host of possibilities with little thought for his/her needs into retirement.

### Historic returns allow for complacency

Domestic markets have delivered outstanding returns over the last decade as seen in the table below.

	1 year	3 years	5 years	10 years
All Share	19.0%	6.5%	15.2%	18.1%
All Bond	15.0%	10.0%	7.9%	11.7%
SA Listed Property	29.6%	12.2%	18.1%	25.1%
AF Money Market	6.9%	9.4%	9.2%	9.7%
MSCI (ZAR)	0.5%	(5.2)%	4.0%	1.5%
CPI	3.5%	6.4%	6.8%	5.8%

*To end December 2010, figures annualised*

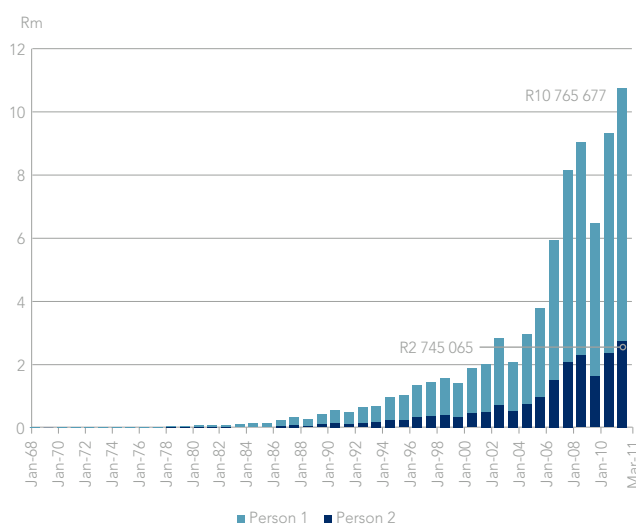
For most it is normal human behaviour to forecast future returns based on these long-term numbers, believing that if they save large amounts closer to retirement, the great returns from the market will bail them out. This is very dangerous. It makes the key assumption that the trends and drivers that supported returns historically remain in place and will continue contributing to growth in the same way. We do not believe this to be true. High historic returns in South Africa were a function of a structural change in inflation, resulting in lower interest rates, declining tax rates, the utilisation of underused capacity and productivity gains. All of which provided support to both the equity and bond markets.

## It's about time in the markets

At Coronation we do not believe it is possible to time markets, but rather it is time in the markets that pays dividends.

The chart below shows the powerful effect of compounding over long periods of time. Person 1 is an individual who contributes R100 per month every month from age 21 to 31. At 31 he elects to stop but leaves the money in the equity market (defined as the FTSE/JSE All Share Index). The end value is calculated when he turns age 65. Person 2 also contributes R100 per month, but from the age 31 to 65 (i.e. 34 years). This money is also invested in the same equity market over the full duration.

### THE POWER OF COMPOUNDING

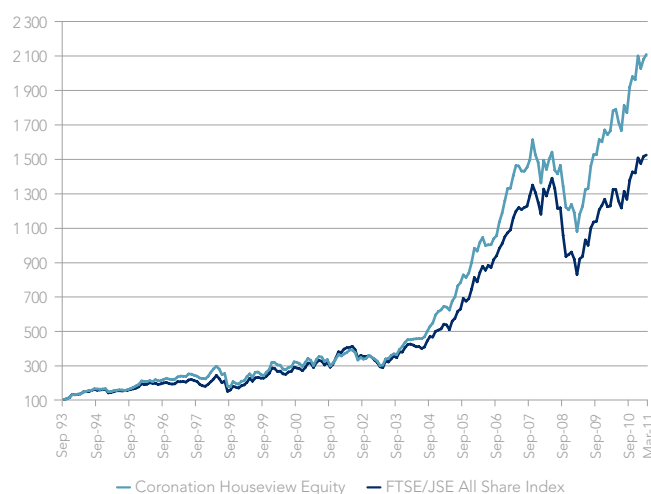


Source: Coronation

The really scary number is that the end value for person 1 is 3 times higher than that of person 2, despite only contributing for 10 years. This is a clear illustration of the powerful effect of starting to save early – and if one does, the required amount is less than what one would need if one started to save at age 40 with a retirement age of 65.

For person 2 to achieve the same end value as person 1, he needs to invest approximately R3 100 per month. An amount that becomes even more onerous if the markets return less in the next few decades (than they have in the past) as we forecast.

Let us take the example one step further and look at the effect of investing with a good manager, where the aim is to outperform the market over the same long-term period. In the example, we have shown the value an investor would have if they had invested R1 000 in the FTSE/JSE All Share Index in September 1993 versus the Coronation Houseview Equity Fund. Once again, one can see that the investor would have an end value that is 38.5% higher than that of the index from being invested with a manager that added alpha of 2.2% p.a. over the duration of the period.



Source: Coronation

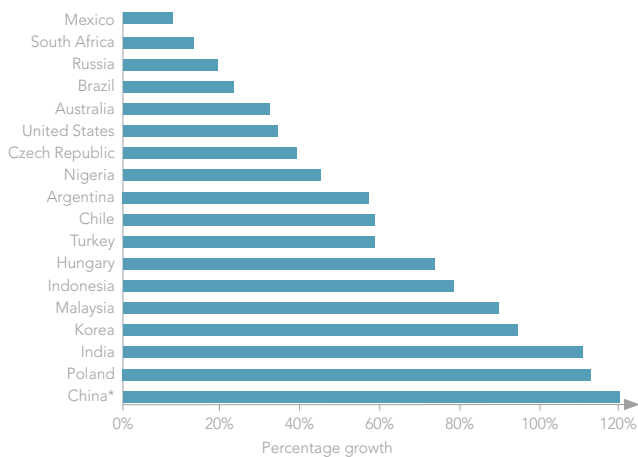
## Going forward we are concerned about returns

We have repeatedly written about our growing concern over future inflation rates globally. We believe that the current and previous decade of artificially low interest rates (and the corresponding credit bubble) will result in higher inflation over the long term. We are also concerned about the returns one can expect from asset classes going forward. Our forecasts are muted compared to historic returns for the following reasons:

- We do not believe that South Africa is competitive from a global perspective – we need to increase our productivity and efficiency. Unfortunately labour costs are a large element of this and any reduction under the current environment is unlikely, making us solely reliant on productivity gains.

From the following graph, it is clear to see that labour productivity growth in South Africa versus the rest of the world over the last decade has been extremely poor.

#### LABOUR PRODUCTIVITY GROWTH, 1990 – 2008



\* China's labour productivity growth was 305% over this period

Source: International Labour Organisation

- Fiscal policy is no longer prudent. Government has signalled its intention to spend more and run larger deficits. Higher spending not paid through higher taxes needs to be funded through net new issuance of government bonds and money market instruments. As a result, government expects to borrow more than R150 billion a year from the bond and money markets over the next three years.

- Government's resultant larger share of the economy and increases in prices administered by government and its associated parastatals will contribute to crowding out the private sector through higher taxes and municipal rates, higher electricity and water costs, toll roads, etc.

The table below shows expected returns from each of the asset classes over the next decade. All are low by historic standards.

#### CORONATION 10-YEAR FORECAST

Growth assets	
Local equity	9-11%
Global equity	13-15%
Property	8.5-9.5%
Income assets	
Bonds	8.5-9%
Cash	7.5-8.5%
Inflation	6%(+?)

Source: Coronation Fund Managers research and I-Net Bridge

Faced with this reality there are two options – start saving early or save more to compensate for the effect of lower returns. For most there simply is not enough available cash to save the extra that is needed. Thus, the best option is to start saving early.

#### In summary:

- Start investing for your retirement early – use the current tax advantage of saving in a retirement fund or retirement annuity – it really is an efficient way to save.
- If you start later – you need a higher allocation.
- Choose the right product – to have a decent standard of living in retirement you need to earn returns of at least inflation plus 5% p.a. over 20 years. Hence, it's necessary to assume some risk in the markets over this time (i.e. equity exposure).
- Choose a good manager and stick with them. The compounded effect of consistent delivery of long-term market outperformance is material to your investment value at retirement.
- If you have started late, top-up with additional amounts on a consistent basis (while the tax incentive remains).
- If and when you change jobs, keep your retirement savings in some form of preservation fund. Do not be tempted to take the cash to spend on short-term needs.
- If you are fortunate enough, top-up your pension savings with additional contributions to a long-term unit trust with a good manager. Do not chop and change – save for the long term.

# A series of unfortunate events

But the more durable worry this year is inflation

by **CHANTAL VALENTINE**

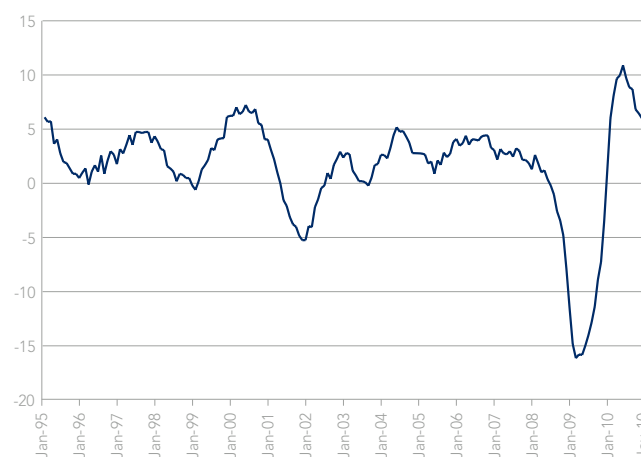


**CHANTAL VALENTINE** joined Coronation as economic and fixed interest strategist in 2003. With 19 years' experience in analysing local and global markets, she plays a critical role in the investment decision-making process.

The quarter was dominated by a series of crises globally, which hit the world on every front: economic, political and natural disaster. The European debt crisis remained a key worry, with further attempts to help the Euro periphery still not fundamentally addressing the sustainability of debt in these countries. Politics dominated the Middle East and Africa, from Cote d'Ivoire's disputed election and subsequent slide into violence to the uprisings seen in a number of MENA countries, including Tunisia, Egypt, Libya, Yemen and Bahrain. Natural disasters were not long out of the headlines, with severe floods in Australia, the earthquake in New Zealand and then the devastating earthquake and subsequent tsunami that hit Japan, leading both to terrible loss of life and property as well as a nuclear crisis. Already on an upward trend, food and energy prices were sent higher by some of these developments. Fortunately, the global growth backdrop had been steadily strengthening, providing some resilience against the sentiment and real impacts of the above events.

In particular, global manufacturing has been very strong – a classic 'V' shape recovery has been in evidence here, and this has been broadbased across both developed and emerging markets. Manufacturing has lost a little momentum recently, but that is hardly surprising given the strength of the rebound (see adjacent chart). This has clearly supported growth and jobs, and has been a particular boon for manufacturing-centric economies; for example, German growth and jobs have performed beyond expectations due to the performance of its manufacturing sector.

OECD INDUSTRIAL PRODUCTION (% Y/Y)



Source: I-Net Bridge


The flip side of this, however, has been continued strong demand for industrial commodities, as well as the manufacturing sector reaching capacity constraints before other sectors. Both these factors have added to global price pressures.

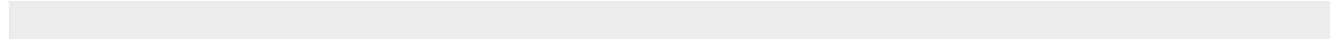
This positive global growth momentum acted as a significant support for South African exports, with the result that South Africa recorded a sizeable trade surplus (R28 billion) in 2010. This limited the current account deficit to 2.8% of GDP last year (from 4.1% in 2009 and 5% – 7% in the preceding three years). In the final quarter of 2010 in particular, the current account deficit was a very narrow 0.6% of GDP. While there was much jubilation

around this number, our take was somewhat different. Yes, the deficit was the lowest since the third quarter of 2003, but it was also the first time since then that the deficit was not fully funded by capital inflows. A deficit is only 'small' if it is easy to fund. There seems to be a significant level of complacency about a wider current account deficit this year, with the general perception seeming to be that (say) 4% – 5% of GDP is not a problem. But our expectation of 4.6% equates to around R135 billion. That is a large amount of money if funding is not forthcoming, and we thus remain concerned about rand vulnerability as the year progresses.

Apart from a few short-lived bouts of weakness, the rand has remained very resilient so far, which has helped dampen some of the effect of global inflation pressures on the domestic inflation rate (which so far remains below 4%, but seems to have clearly turned upwards). However, even despite the rand's strength it is undeniable that global pressures are starting to make themselves felt. The most immediate and clear impact comes from fuel prices, where the April petrol price hike (also including other levies/taxes) will see the retail price of petrol 23% higher than its recent low in September 2010. Food price inflation, while still low at consumer level, has clearly turned up sharply and recent PPI data indicate more to come.

The SARB so far is indicating the 'usual' response to commodity price shocks: that it will not respond to first-round effects, but will wait to see if there are second-round effects before responding.

While this is a textbook response, it is one that worries us. To begin with, food prices (more so than petrol) usually do have second-round effects, because of the importance of food in low-income earners' spending baskets, and therefore there is a consequential impact on wage negotiations. Secondly, because wage negotiations are already high relative to consumer inflation – it is still early in the wage season but settlements so far seem to be coming in at double or higher than latest CPI numbers. And last, but definitely not least, we are worried that we are beginning from a point where we have very easy monetary policy, which makes it easier for second-round effects to take hold. On the SARB's own inflation forecast, the (forward) real repo rate is slightly negative at the moment – a situation we simply do not believe is justified against a background of near 4% growth rates, and where inflation pressures are building. The SARB's approach currently seems to echo that of the Federal Reserve (whereas the European Central Bank is taking a much tougher line on inflation). And as in the US, breakeven inflation rates (inflation expectations derived from the bond market) have been rising, presumably as investors worry about inflation outcomes in light of continued easy policy. In South Africa, most breakeven inflation rates are above the upper bound of the 3% – 6% target range. Our own expectation is that inflation will breach the upper end of the target later this year, that second-round effects will become more obvious, and that the SARB will start raising rates before year-end – most likely, in the third quarter. 



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# Bond outlook

## Inflation and supply factors

by **MARK LE ROUX**



*MARK LE ROUX is responsible for the fixed interest investment process and portfolio management functions for both institutional and retail portfolios. Mark has 20 years' experience in managing both traditional and alternative portfolios.*

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The bond market experienced conflicting effects from the many crises that impacted the globe over the past quarter. On the one hand bonds benefitted from a safe haven bid, but on the other, inflation fears intensified driven by already-tight food and oil markets.


SA bonds continued to follow the lead of US Treasuries. Both benefitted from a safe haven bid and large purchases by the Bank of Japan as it intervened in foreign exchange markets to try to prevent the yen strengthening following the earthquake. Treasuries (and SA bonds) had weakened significantly in late 2010 and during the first quarter of this year, but the flight-to-safety has put a lid on weakness for now.

We continue to see upward pressure on inflation globally as a result of higher food and fuel prices, and these are now beginning to feed into South African inflation in a more concrete way as detailed in the preceding article.

On the fiscal front, a somewhat better than expected revenue number for 2010/11 led to a provisional downward adjustment in the budget deficit to 5% of GDP (from an estimate of 5.3% at the time of the budget in February). This is, however, still a large number and bond supply into the market will also remain relatively high.

We thus remain concerned about bond yields from both inflation and supply factors. (History has shown that supply tends to impact more as it happens rather than for it to be discounted in advance.) These domestic concerns are further deepened by an expectation that US bond yields will continue to rise over the course of the year as growth and inflation expectations continue to strengthen, concerns over the US fiscus grow, and as the

eventual end of quantitative easing and the zero interest rate policy draw nearer. Pressure on US bond yields will likely see global yields rising, including South Africa.

In conclusion, we retain an underweight relative to benchmark modified duration in the fixed interest portfolios and continue to hold inflation-linked bonds. 



# Equity market update

## A challenging market environment

by **QUINTON IVAN**



*QUINTON IVAN joined Coronation in April 2005 as an equity analyst. He currently analyses retail, construction and pharmaceutical stocks. Quinton co-manages the Coronation Equity, Balanced Plus and Industrial funds as well as the Houseview portfolios.*

The global events of the past quarter are likely to see the US Federal Reserve keep interest rates lower for longer. The combination of accommodative global monetary and fiscal policy together with rising food and oil prices is likely to lead to higher inflation. In this scenario, equities remain our preferred asset class for producing inflation-beating returns. We continue to find more value in global equities and are close to the maximum offshore limit.


The FTSE/JSE All Share Index returned 1.1% for the quarter, masking significant intra-quarter volatility. Resources continued to lead the market higher returning 2.8%, while industrials returned -0.3% and financials 0.7%. We remain underweight resources with the view that the upside to long-term valuations, based on mid-cycle earnings, is not attractive enough to justify a higher weighting. Our preferred resource exposure remains Sasol given its long-life assets, low-cost base and attractive valuation at 10 times our assessment of normal earnings. We remain underweight gold and platinum producers given our concerns over declining grades and significant cost pressures faced by these businesses. During the quarter we added to our holding in Mondi Limited, an integrated global paper and packaging company with operations based primarily in Europe and Africa. Mondi enjoys a leading market and cost position in many of the segments in which it operates. Earnings are currently depressed and should recover strongly with the global economy. Approximately 60% of revenue is exposed to faster growing emerging markets, and with its low-cost producer status has remained profitable when the majority of the industry was either lossmaking or breaking even. Management is very return focused and extremely shareholder friendly. Mondi offers good value, trading at 9.6 times our assessment of normal earnings in euros.

Banks returned 1.1% for the quarter, marginally outperforming other financials. We remain overweight banks and have added

to our position during the quarter. Valuations of the large commercial banks remain attractive at 10 times 1-year forward earnings and price-to-book ratios of 1.8 times.

We remain concerned over the strength of the rand and underlying inflationary pressures faced by the real economy (labour, electricity, property rates and taxes). These concerns were reinforced during the quarter by a disappointing budget speech. Expected budget deficits for the upcoming fiscal years were revised higher, which means funding is likely to remain high when compared to prior years. While supply was relatively well-absorbed last year, this was on the back of strong foreign buying. It is doubtful whether this will continue into the future. The likely outcome is higher bond yields and a weaker currency. It is for this reason that approximately 59% of our client portfolios are invested in rand-hedge counters that are attractively valued and globally diversified.

Inflation remains a threat to the South African economy. We believe the market is underestimating the extent of food inflation and pass-through into second-round effects, especially in the current low interest rate environment and continued high wage settlements (without commensurate productivity gains). Given these pressures, we continue to favour defensive businesses that are undervalued and enjoy pricing power such as Naspers, SABMiller, Famous Brands, AVI and the Spar Group. We continue to find value in selected small caps with many trading at around six times our assessment of normal earnings. Approximately a third of our client portfolios are now invested in shares outside the FTSE/JSE ALSI40.

In conclusion, markets remain challenging. In an environment fraught with uncertainty, we remain resolute to our proven investment philosophy of investing for the long term. We believe this is the best way to add value for our clients. 

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# Grave dancing

*How 'bout a little bit, a little bit of moonlight dancin'  
underneath the starry sky?*

*How 'bout a little bit, a little bit of moonlight dancin'?*

*Just the moon and you and I.*

*Mmm, just the moon and you and I.*

– **Bette Midler**, from the album *“Some People’s Lives”*,  
song written by **Diane Warren**

by **DIRK KOTZÉ**

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**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.

In our investment parlance, a ‘grave dancer’ is one who invests in bombed-out and broken companies, in the expectation that they will recover. This particular form of value investing comes with obvious risk. By the time an out-of-favour company is offered cheaply, its prospects are typically dire. Reversion to the mean is a great concept in theory, but in the real world, challenged companies can fail and lose the investor’s capital altogether. The art of grave dancing involves side-stepping the broken bottles so that you don’t cut your feet. Given that we manage other people’s money, the risk of capital loss must be weighed carefully against potential return.

This article is about the contract mining industry, and our increased interest in it. Coronation’s involvement with contract mining started in mid-2008 when the former leasing division of Imperial listed as Eqstra Ltd. Prior to the listing, in 2007, Imperial had acquired MCC, a contract mining business, and injected it into this division. We were familiar and comfortable with the stable leasing businesses, and were able to satisfy ourselves that the newly acquired business had exciting prospects. We became enthusiastic investors in Eqstra, and its biggest institutional investor. The investment regrettably did not go smoothly: we negotiated various disappointments and supported a rights issue. At the time of writing, however, Eqstra’s earnings recovery is firmly under way and its prospects look good.

In any challenged investment case, the first step is a thorough re-examination of the fundamentals. Our research typically includes contact with customers, competitors and suppliers. The initial work on Eqstra and later follow-ups thus led us to a broader understanding and a high level of conviction on the fundamentals of the industry. It also led us to the existence of investment opportunities in the competitors Buildmax and Sentula. And so

we came to own not only one, but all three of them. This is a useful illustration of the investment process in action, and how we distinguish between cycles or mean reversion, and structural changes. But first we should explain what these companies do, and how they make their money.

Contract mining, as we discuss it here, is the business of digging topsoil, waste material and mineral-bearing ore (or coal) from open-cast mines. Typically the contract miner gets paid by cubic metre of material delivered to the desired spot, as agreed with the mine owner. The agreed rate encompasses the entire cost of buying and financing the equipment, and providing staff to operate, service and maintain it. At the end of the job, the contract miner sells the equipment for its own account, or moves it to another mine. The equipment is expensive, making the business capital intensive. It is also typically financed by debt, bringing financial risk into the equation. The business can be subject to the vagaries of rain in the pit, labour disruption and contract cancellation when commodity prices drop or the mine runs out. It can be a volatile and tough business, but if well managed, it can be rewarding with high margins and good returns on capital. Over the years the industry has had its cycles, but the business model has proved its worth and there is a place for it. Outsourcing is in fact increasing, making this a growth industry.

Why outsource? This is the first question one would ask. The answer is paradoxically that most mines don’t. Long-life mines with stable ore bodies typically belong to first-tier mining companies with sufficient expertise and capital to undertake the ownership and operation of the equipment themselves. However, there are many (and increasing) instances where outsourcing makes sense. Contract mining provides flexibility.




If you produce a commodity with a volatile price, you may want to start up when prices are high and switch off when they fall. Particular ore bodies may have only a three or four year life; hence you'll end up with the resale risk on the equipment if you do it yourself. If you are a junior mining company, your balance sheet may not be sufficient to buy a fleet of mining equipment, or you may not have the in-house expertise to undertake the mining activity yourself. It may also be that you need big equipment for the first phase of mining and smaller equipment once the pit gets deeper. All these needs can be professionally met by the contract miner. The contractor, working say 10 different pits rather than just one, can optimise equipment usage more easily.

But easy it isn't. Practically the entire industry, whether listed or not, ran into serious financial trouble in 2009 and 2010. Eqstra, Sentula and Buildmax had to be recapitalised by rights issues. However, worse than merely a bad cycle, this downturn revealed serious problems with the business model of contract mining companies, and with its competitive dynamics and pricing power. To explain this we need to make a few sweeping generalisations, in the interest of simplicity. For many years, the contractors were family-owned companies, servicing their powerful corporate customers well, but in a somewhat unequal relationship. Implicit in the deal was flexibility: the contractors worked when the mine owners had work for them, and when there wasn't any, went to work elsewhere. There was no question of kicking up a fuss or holding the mining company to a contract: you simply had to retain their goodwill or risk not getting the job next time.

While the world was growing, this worked well enough. Used mining equipment could easily be sold, and their proceeds would lay off the outstanding bank loans. But a sure thing attracts many entrants and contract mining rates started drifting downwards. Existing players defended their market shares by cutting prices, eagerly pushed by the mining customers.

Eventually rates no longer reflected the economics of the service and did not leave sufficient margin for replacing machines when they aged. Having created a perfectly competitive supplier base, the mining companies sat back in satisfaction. When the financial crisis struck, they shut their pits and blithely sent the contractors home, leaving them to face the consequences. But the cracks in the business model were revealed. The market for used equipment dried up, making it impossible for cash-strapped contractors to sell their surplus equipment. In trouble with the banks, they now had to raise capital from a position of weakness. And providers of fresh capital wanted assurances that their money would be repaid.

And so the cycle kicked upwards. The mining companies found that having viable contractors is actually in their interest. They now appreciated that no-one would spend a couple of hundred million without a proper contract with water-tight cancellation clauses. Higher rates were negotiated across the industry. Inefficient practices were washed out of the system, and management changes happened at almost every contracting company. Perhaps most important of all, supplier and customer sat down together and worked out a system where each would assume those risks appropriate to them, risks that they could manage more effectively. Contract terms, formerly skewed towards the customer, returned to a mid-point. It took a major crisis, but the industry emerged with much improved fundamentals.

Our work on a troubled investment helped us to understand that all the changes in this niche industry were not merely cyclical, but some were structural. The conviction that the industry would be improved, gave us the confidence to retain our investment in Eqstra, underwrite a rights issue in Buildmax and establish a new investment in Sentula; all at a time of extreme negativity regarding their prospects. We think that all three shares are cheap and offer large margins of safety. Their share prices have started to recover, but there is still a long way to go. Little bit of moonlight dancin', anyone? 

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# Risk in Africa

## Not simply a number

by **PETER TOWNSHEND**



*PETER TOWNSHEND joined the Africa team in July 2008. He currently co-manages the Coronation Africa and Africa Frontiers Funds. Prior to joining Coronation, he worked as an analyst with an African hedge fund.*

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In calls with investors, we are usually thrown a question on risk, generally along the lines of 'how do you measure risk in your African portfolios and how do you account for it in your valuations?' While we think we understand the question, we are at a loss as to how to answer it in the way that the person asking the question probably wants. It's a bit like 'define the universe and give two other examples'.

Clearly, investing in Africa carries additional risks to those which investors typically encounter in more developed markets. The risks that we'll discuss in more detail include:

- Markets are small and illiquid
- Government is often inefficient and immature
- Reporting and governance levels can be inadequate

Kenya and Nigeria are two key markets for us and it is worth remembering just how small they are. Nigeria has a total market capitalisation of \$56 billion and trades around \$450 million per month, while Kenya has only a \$15 billion capitalisation and trades \$100 million per month. By developed world standards these are tiny markets and illiquidity can be a real killer – we know of one fund that went under during the 2008 financial crisis and both Egypt and the Ivory Coast have been closed for periods this year as revolution rages. We naturally measure and track liquidity and have liquidity limits in our portfolios, but the reality is that when we need it most liquidity in these shallow markets is likely to dry up considerably. And, as recent events have shown, markets in which we invest can close for long periods.

The countries we can invest in cover the spectrum from ill-tempered and fragile unity governments (Kenya and Zimbabwe), monstrously inefficient and corrupt 'democracies' (Nigeria and The DRC) to dictatorships (Egypt and Tunisia, until recently). Even where we invest in supposedly stable and democratic countries (Zambia and Ghana), it is only a few decades since they too were military/socialist dictatorships. Further, while state control of the economy is being lifted in many countries (Zambia and Ghana), some countries are moving the other way (Zimbabwe). Of course we have country limits in our portfolios and closely monitor developments. But, the reality is that we invest in lively neighbourhoods and while Africa as a whole is developing, this advancement is unlikely to be linear. Surprises are almost guaranteed.

Finally, many of the businesses we come across do not meet what would elsewhere be considered minimum standards of financial reporting. Disclosure can be poor and reports many months late. The idea of good corporate governance is an emerging concept in many countries, as is interacting with investors. This is not to say that businesses are poor quality or their accounts dodgy but, getting comfort on the quality of a business, its management and its numbers, can take a lot of effort.


So, to return to the question of 'how do we measure risk in our Africa portfolios and how do we account for it in our valuations?' We measure those risks that we can and apply what we consider prudent limits on where we invest. And, implicit in the ratings we apply to companies and in our valuations, is a country and company discount factor. By some commonly used measures, investing in Africa is less risky than

you might think. For example, the standard deviation on our Africa Fund is 26%, substantially lower than the 34% of the MSCI Emerging Markets Index.

But, risk is a very broad term, not a number. In its simplest form as applied to what we do, we would agree with James Montier, that risk is the permanent loss of capital\*. And that is the risk that we try to manage for our clients. The best way that we know of doing this is to invest in high quality businesses, occupying dominant, defensible, market positions and with good management and governance standards. These characteristics give us higher conviction in our valuations. Most importantly, we then look for a wide margin between this valuation and the market price.

The very issues raised in this article often result in potential investors overlooking the opportunities available. Comments

such as 'I don't need to own Zimbabwe' by competing investors are music to our ears. In a world flush with liquidity competing for very limited investment opportunities, finding a neglected neighbourhood with extremely attractive valuations cannot be ignored, in our view. We make no pretences as to the potential volatility investors might experience, but we do think we offer up interesting opportunities for investors who can stay true to the mantra of 'long term'.

Given our limited universe of investable companies, not all companies in which we invest meet all of these criteria all of the time. But that is our benchmark and we seldom stray far from it. Economies will remain cyclical, Africa will continue to throw up nasty surprises and exchanges will be disrupted. But, by sticking to our value philosophy and investing for the long term, we think we will do an acceptable job of managing what we define as risk. 

\* **James Montier** – *The Seven Immutable Laws of Investing*

# International outlook

Perspective amongst the chaos

by **TONY GIBSON**



**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.

Anyone who regularly reads our international commentary will know that we pretty much always end with the same conclusion – the gist of it being that serious investors should be prepared to select a diversified high-quality share portfolio and hold it for the medium term. Such an approach will, over time, prove to be the best growth asset – and certainly the best inflation hedge. For those readers who may find this irritating, I apologise in advance as this article will be no different! Despite the last 10 years producing sub-par returns from international equities – following the crashes of 2001/02 and 2008 – we remain

committed to the belief that high-quality equities produce excellent returns given sufficient time.

With that out of the way, let us now turn to the currently very trying and complex investment environment.

There certainly has been no shortage of events that added to investor anxiety in recent weeks. A combination of the Japanese tsunami and nuclear reactor damage, ongoing unrest in North Africa and rising oil prices, served to unsettle investors' nerves,

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resulting in a sharp market reversal in mid-March. While history books will undoubtedly attribute the March correction to these factors, they will probably draw the incorrect conclusion. The actual reason for the pullback was in reality a far less complex one and simply relates to the fact that equity markets became overheated in early March. A number of technical indicators showed (according to those that monitor them) that a correction could be in the offing. As an example, in mid-February, the well known 'Crowd Sentiment Poll' recorded a bull market-high reading of 72.3. This was well into expensive optimism territory and higher in fact than the 70.7 reading in April 2010, which immediately preceded the nasty April to July 2010 correction. Added to this is that flows into US equity unit trusts had turned strongly positive, having been negative for all but a few months following the equity market bottom in March 2009.

The point that we are making is that equity markets were becoming overheated in the short term, and needed to correct. Whether it was the Japan tragedy, the Libyan crisis or an oil price hike, some or other factor would inevitably have sparked a correction. To give this some perspective, we should cast our minds back to 1987. In October 1987, equity markets across the world fell by the biggest one-day fall in the history of financial markets.

It is interesting to consult the history books as to what caused this fall. The consensus explanation revolves around the perceived international disputes amongst the so-called G7 industrialised nations who were squabbling about the most appropriate monetary and currency policies at the time, in the face of some inflationary pressures in the US. Again, closer to the truth in our opinion was a more simple explanation. Equity markets were very overvalued and any excuse would have been sufficient to set off a spate of panic selling. In the case of October 1987, it was computer-generated 'program trading' which set the ball rolling. In reality, however, it was because many investors – intuitively believing that equity markets were vulnerable – had been attempting to engage in 'portfolio insurance' strategies in an attempt to hedge their equity portfolios. It therefore became self-fulfilling that markets would fall as the weight of those seeking portfolio insurance overwhelmed them.

As is often stated by sensible market commentators, equity markets like to climb the 'wall of worry'! Any hint of bad news will inevitably cause an over-extended equity market to fall sharply. Conversely, as was the case in 2009, it does not take

much in the way of good news to trigger a significant market rise when equity markets are depressed.

Turning to current investment conditions, there have clearly been some severe road bumps experienced during the February to March period. While it is impossible to ignore events in the Middle East and Japan at the moment, it does seem that global markets have come to terms with the events that have taken place. Having fallen sharply in mid-March, the month ended essentially flat. The conclusion implicit in this reaction is that global economic growth – especially in the US – has not been derailed from its current recovering trajectory. Some of the key statements that investors are making are as follows:


- Following the sudden widespread instability in the oil-producing world, the main risk to global markets remains the impact of the rising oil price, rather than the damage done to manufacturing capacity in Japan. This situation, if it worsens, could represent a risk of a significant disruption in the supply of oil. Although a more dangerous outcome in the Middle East and North Africa remains a risk, an expansion of the recent turmoil into Saudi Arabia does not seem to be happening. Also, the scale of violence in the majority of affected countries has been limited and no-one appears interested in destroying the oil-producing infrastructure. This would largely explain why the oil price rise has actually been relatively muted in the face of many uncertainties.
- Importantly, economic data continues to improve – most notably in the US. As was recently reported, the Fed raised its 2011 GDP forecast range to 3.4% – 3.9%; an increase of 0.4% from the previous forecast.
- The expectation is, despite some evidence of inflationary pressures in the US, that the Fed will not increase interest rates for quite some time. The Fed chairman clarified this by stating that 'until we see a sustained period of stronger job creation, we cannot consider the recovery to be truly established. It will be several years before the unemployment rate returns to a more normal level'.
- Few commentators are predicting a hard landing for the Chinese economy. This is despite the reserve requirement for banks recently being increased for the 18th time. The logic being that economic activity, and more importantly food inflation, has been moderating of late.

- In Europe all is not bad news as growth continues to recover. February PMIs positively surprised, December industrial new orders exceeded expectations while both consumer and business confidence increased. Northern Europe continues to drive this recovery. Swedish GDP grew by an astonishing 7.3% in the fourth quarter of 2010, while German unemployment remains at near record lows, and business confidence rose to a record high on the back of strong exports and consumer spending.

There are of course risks out there which will potentially affect equity markets. The most important, not surprisingly, relates to the outlook for company profit growth. It must be pointed out that, on balance, the most recent set of corporate profit announcements were rather less positive than we have seen over the prior 18 months. There seems to be a number of reasons for this. Firstly, after a sustained period of significant positive earnings surprises, expectations have been raised. Secondly, many companies are reaching a stage where extraordinary cost reductions achieved in the last recession have reached their limit, and with the current resumption of revenue growth they are starting to increase fixed costs again. Thirdly, cost inflation is starting to bite – particularly in commodity and energy inputs. The return to sales growth is therefore not being accompanied by the expected operational leverage for some companies. Inevitably, this trend will raise some interesting stock-picking opportunities as there is the potential for significant dispersion in company performance as companies experience differing success in passing through cost increases to their customers in the quarters ahead.

Japan will inevitably experience a period of economic shrinkage due to energy-related disruptions and production problems. However, the commencement of reconstruction work should prove to have a stimulatory effect on the economy. Despite this setback, the investment case for Japan remains in place. Many companies are trading at, or below, book value, while they are significantly more profitable at this stage of the industrial production cycle than previously. Partly this reflects higher margin exports to the rest of Asia, but it also follows from the adoption of increasingly asset-light business models and much improved industrial structure. Has the market's perception of risk assets such as Japanese equities changed? In the immediate aftermath it clearly did, but the speed with which the equity markets have recovered their poise suggests that participants are, generally speaking, still underweight risk.

In essence the key to global growth, and hence equity markets, will largely be determined by monetary policy for some time yet. Although monetary tightening has become a feature in developing economies in recent months, it is increasingly on the agenda in the developed world. The European Central Bank has increased rates by 25 basis points and the Bank of England is also warning of a tightening in policy. That said, we believe that interest rates will remain supportive of economic activity for a protracted period – even in a less than ideal period of stubbornly high inflationary input costs.

Until such time as central banks are free to raise interest rates without fear of the sociopolitical repercussions, we will remain in an equity-friendly environment. This is especially when compared to the alternatives of cash or fixed-interest investments which offer no protection against the erosive effects of inflation. 

# International portfolio update

## ■ Coronation Global Equity Fund of Funds

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Jul 00	14.14%	4.59%	4.50%	3.91%
Benchmark		14.03%	0.34%	2.64%	1.64%

Annualised, quoted in USD

The fund returned 4.8% for the quarter, bringing the rolling 12-month performance to 14.1%.

It has been an eventful quarter, starting with the floods in Australia and ending with the UN military intervention in Libya. Despite the myriad of unsettling events, the world economies seem to be gathering strength, building momentum from a number of positive headline figures. Markets rose strongly into 2011 on the back of an improving economic situation, but the tragic events in Japan and unfolding political change in North Africa and the Middle East caused a sharp market downturn in mid-March, only to recover by month-end.

In terms of regional equity performance, Japan was the worst performing region, falling 4.9% (in US dollar terms), while Europe performed best, rising 6.6% (in US dollar terms). North America was also strong, finishing up 6.1% while Asia (excluding Japan) rose 2.8%. The fund's regional positioning detracted slightly from performance over the quarter.

Contrarius Global and Indus Select underperformed due to an overweight exposure to Japan. While there will be supply chain disruptions and a period of economic contraction, the market correction was probably overdone and the tragic events could be a catalyst to reignite a flailing economy. Morant Wright Japan holds mostly companies with domestic exposure which explains their underperformance this quarter.

After a period of strong performance the European managers underperformed. This was due to their being on the wrong side of a strong rotation into banks and energy stocks in January and February. They recovered somewhat in March but not enough to compensate for the earlier underperformance. During the quarter we added a new fund to the portfolio. Mennom European Fund is managed by Laurent Saglio who has an excellent long-term track record of investing in Europe.

Unlike Europe, the US managers had a strong quarter with Royal, Viking and SEG Great Jones all adding alpha. Royal's performance has picked up after a disappointing run, which is pleasing. While they have been right on many calls, these have taken a while to play out – a frustrating scenario but expected when investing in a contrarian, long-term manner.

We see monetary policy as critical to global economic growth and despite the strengthening in the recovery; we believe it is too early for policy-makers to risk raising rates just yet. We expect this to remain as the foremost concern for policy-makers, therefore keeping rates low and an environment distinctly biased towards equities.

## ■ Coronation Global Capital Plus

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Sep 09	9.03%	–	–	11.22%
Benchmark		4.83%	–	–	1.92%

Annualised, quoted in USD

It is important to separate the human impact and economic impact of the unfolding catastrophe in Japan. From an economic perspective, Japan's short-term growth assumptions were reduced, but the result of the reconstruction programme may add to longer-term growth prospects in both Japan and the rest of the region. As an indication of the volatility financial markets faced, the Japanese market fell by just over 20% over the three days subsequent to the earthquake, and rebounded by almost 19% over the following two weeks! Such volatility in one of the largest financial markets in the world is almost unprecedented, reflecting the fear and uncertainty facing such a large economic region. A reminder of the power of compounding reflects that a market that was down 20%, recovered by almost the same amount, but would still leave investors down 5% over the period



at the time of writing – communicating the importance of preserving capital over periods of market volatility.

The fund returned 2.49% over the quarter, a very satisfying outcome given the challenges. The MSCI World Index produced a positive 4.9%, the Global Bond Index 0.7%, and global listed property performed well, producing 5.5% over the quarter.

The fund's equity holdings did not perform well in relative terms, but have arrested the disappointing trend of the previous two quarters. Our listed property holdings were negatively impacted by the Japanese holdings, although only one position (Japan Retail Fund) is still substantially down from the pre-quake levels. Over the last 12 months the fund has benefitted hugely from its listed property positions, despite the recent setback. The position in physical gold continues to add to performance, although we did trim exposure slightly as we are starting to see it as a consensus trade. Our natural gas position continued to detract over the quarter, although (recently) benefitted from the anticipated increase in demand for liquefied natural gas post the earthquake. We remain confident that the fund will profit from this position over time.

We actively added to our equity exposure, mostly by increasing exposure to Japan. While we have held a positive view of valuation levels of Japanese equities, we have not held (prior to recent events) significant exposure to that market. Given the significant change in pricing, we have also shifted some of our US exposure into Japan – on a see-through basis exposure to Japan is now approximately 15%. We also added to our property exposures, particularly in Singapore and Australia. And towards the end of the quarter swapped some direct equity exposure for call options on the US market, thereby limiting our downside without giving too much away in potential upside participation. The implied volatility cost of these options is very low relative to history. We maintain our view on fixed interest, and will only materially change the fund holdings should global bonds sell-off significantly.

Within the direct equity positions, the fund remains biased towards defensive businesses like Heineken, Tesco, Vodafone and Imperial Tobacco, but has some exposure to the more cyclical shares like Cisco, CVS Caremark and Warner Music. In terms of equity funds in the portfolio, two funds were introduced as longer-term anchor tenants, which should reduce volatility over the longer term.

The fund remains biased towards the US dollar. Given the weakness recently experienced, this position hurt over the quarter. We retain a reasonable position in the British pound after the period of severe underperformance in the last two years.

### ■ Coronation Global Equity Alternative Strategy Fund of Funds

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Aug 96	6.99%	3.36%	3.47%	9.22%
Benchmark		8.76%	0.68%	3.96%	5.00%

*Annualised, quoted in USD*

Developed markets rose with an encouraging economic outlook in January. However, developing markets declined with mounting inflationary pressures and the instability in the MENA region. Chinese GDP for the final quarter of 2010 was confirmed at an annualised 12.7%; however, China increased the reserve ratio for domestic banks and a number of emerging market countries raised interest rates to counter inflationary pressures.

The tragic natural disaster in Japan and the escalating conflict in Libya saw the MSCI World Index suffer close to a -7% correction during March, before recovering strongly to end the month down -0.94%.

Global managers contributed 1.1% to fund performance, with the top performing manager returning 4.4% for the quarter. The manager ran an average net exposure of 41% for the period and performance was driven by good stock picking. The top 10 holdings averaged close to 40% of the fund during the period.

In terms of the US, managers contributed 0.7%. The top performing US manager, with a return of 5.4% runs a concentrated portfolio. The manager's top five holdings in March totalled 69% of the fund, with three of the top five stocks up more than 14% in the quarter, with one returning 27%.

The European and Asian managers detracted from overall fund performance. The best performing manager returned 6.2%, driven by good stock picking with two of his top five holdings rising more than 23% in the quarter. The worst performer returned -4.2% as a number of his top holdings came under selling pressure in January. This same set of long-term holdings is

what contributed to him being the top manager in Global Equity Alternative Strategy for 2010.

The effect of currency contributed about 0.5% during the quarter.

## ■ Coronation Global Emerging Markets

	Launch date	1 year	3 years	5 years	Since inception
Fund	14 Jul 08	21.40%	–	–	14.76%
Benchmark		18.78%	–	–	6.99%

*Annualised, quoted in USD*

The fund had an excellent quarter, outperforming the benchmark by 3.9%. Although this performance is very pleasing, we believe a longer-term measurement period is more appropriate for comparing returns. On a one and two-year basis the outperformance totals 2.6% and 7.6% respectively. Since inception the fund has delivered alpha of 25.9%, equivalent to 7.9% annualised.

We are confident that, on the whole, emerging markets continue to offer reasonable value for investors. The MSCI Emerging Markets Index trades at 11.5 times this year's earnings, but this disguises large differences in valuation between certain sectors. Broadly speaking, commodity and resource-related sectors are trading at low multiples, but on earnings that are temporarily inflated by commodity prices that are above what we consider sustainable in the long term. At the opposite end of the spectrum, many consumer-facing businesses are trading at valuations that can only be justified if they achieve earnings growth of 20% or more for many years to come. We believe that in this environment a long-term investment horizon that is premised on paying reasonable multiples on sustainable 'normal' earnings is of critical importance in order to avoid buying businesses that appear cheap, but whose earnings are temporarily elevated, or that require unrealistic future profit growth in order to justify an investment today.

Our holdings in Chinese internet-related stocks have performed exceptionally well. Sohu and Netease were 9% of fund at the start of 2011 and returned 41% and 37% respectively for the quarter. We used the opportunity to halve our exposure to these companies and buy two other Chinese internet (animated) gaming stocks. Both new additions trade at less than 10 times earnings, adjusting

for their sizeable cash balances. Online gaming businesses are highly cash generative as users typically pre-purchase the virtual 'currency' that they then redeem during gameplay to access premium features. Successful games attract large, loyal followings and can remain fashionable for several years, giving the developer a window to develop and test new offerings.

We also introduced Tsingtao, the second largest brewer in China behind CRE (which the fund previously held). The flagship Tsingtao brand is the only domestic premium brand in China and the country's only international beer brand.

China's beer market is the biggest in the world by volume, but only the ninth largest by total profits. This is as a result of high fragmentation (every region in the country has multiple breweries) and low pricing (entry level beer is cheaper and has a lower margin than bottled water). The country is in the early stages of both consolidation, where smaller brewers are absorbed by larger ones, and premiumisation, where consumers migrate from entry level beers towards higher margin premium beers. We believe that over time the profit pool will grow substantially as pricing becomes more rational and profits will be shared between fewer brewers as the big players start to dominate. This dynamic has played out countless times in every other major beer market in the world and there is no structural reason why China should be any different. Tsingtao should benefit greatly as consumers migrate upwards over time.

Elsewhere, we have spent much time looking at the Indian market, including a recent trip to India where we met with more than 40 companies. For much of the almost three years since the fund launched, India has appeared expensive relative to other emerging markets, and our Indian holdings have been very limited. We believe that the public sector banks (PSBs) offer compelling value and have added Punjab National Bank (PNB) to our existing holding in Bank of Baroda (BOB). Total PSB exposure of the fund is now at 6%. India is very underpenetrated from a banking perspective: there are over 600 000 villages and the sum total branches of all the banks in India comes to only 72 000. BOB and PNB are well respected and conservatively run, providing the opportunity to benefit from the growth in credit extension, consumer spending and infrastructure development taking place in the country. But at single digit earnings multiples they trade at a fraction of the valuation that one would pay for some of India's flagship blue-chip corporate and fast moving consumer goods companies.



## ■ Coronation Global Bond

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Oct 09	8.90%	–	–	4.66%
Benchmark		7.29%	–	–	2.53%

Annualised, quoted in USD

Bonds continued to exhibit a weaker tone during the quarter. The Citigroup WGBI returned 0.66% in US dollars while the fund returned 2.72%.

The US market was particularly volatile as a background of strengthening economic data was punctuated by rising geopolitical risks. The yield on the US 10-year Treasury traded as low as 3.17% and as high as 3.73%, to end the quarter at 3.47%. The inflation-linked markets reveal that the majority of this yield movement was driven by movements in real yields, as break-even rates of inflation steadily widened throughout the quarter from 2.3% to 2.53%.

European bond markets proved to be the laggards as the ECB signalled an end to low rates in place since May 2009; the rate increase at their April meeting was well-flagged in advance. German bonds were 2.3% lower during the quarter as yields in shorter maturities rose significantly. Once again returns within the eurozone showed a wide dispersion, with Portugal down 9.1% in local currency terms and Spain up 2.2%.

Yields on peripheral government bonds continued to rise at a faster rate than core markets. Greece remained under pressure, Irish 10-year yields rose by another 1%, and Portugal by over 1.5%. With large refinancing looming, Portugal was forced to become the third nation to seek the assistance of the European Financial Stability Facility (EFSF). The debate surrounding the structure and workings of the EFSF and its replacement post-2013 (the European Stability Mechanism) continues. The debate surrounding the role of bond holders, particularly senior ones, in any future restructuring also remains a hot topic.

Rising Japanese bond yields reflected the weaker global bond backdrop. However, the steeper yield curve was reflective of a renewed concern surrounding Japan's high debt/GDP ratio in light of developments within Europe. The earthquake and subsequent tsunami have merely compounded Japan's

problems, with the cost of rebuilding and loss of output putting further strain on government finances. The hope must be that this tragic event acts as a catalyst for change and allows for decisive political leadership.

From an economic perspective the main challenges facing bond markets stem from the rapid rise in commodity prices and their effect on inflation. The political unrest (rising food prices cited as a catalyst) in North Africa merely exacerbated the rise in oil prices which are up over 50% in the last six months. Commodity price rises, however, have been much more widespread than just oil, with cotton also up 50% in the last six months and a wide basket of commodities up 10% on last quarter's more than 15% increase. The root cause of these price rises is debatable, with geopolitical risks, supply, demand and ultra-low interest rates all playing their part. Central bankers and the bond markets both remain focused on the possible second round effects on inflation from the rise in input prices.

The environment of low official interest rates and an improving economic environment continue to fuel a strong rally in corporate bond markets, particularly in higher yielding instruments. Many corporate bonds are rapidly approaching pre-crisis levels. Rising issuance in lower-rated credits and the dilution of covenants as well as the pickup in corporate mergers and acquisitions should all sound alarm bells for bond investors. The macro environment remains far from certain and investors need to be conscious of this when assessing the risk premium they demand for holding corporate bonds.

In the foreign exchange markets the US dollar remains poorly supported, and the rising interest rate differentials between Europe and the US have contributed towards continued outperformance of the euro. The yen had started to settle into a range prior to the earthquake but subsequently rallied on repatriation fears prior to the G7 intervention. This intervention opens the door to potential yen carry trades if investors can be confident the authorities will act to prevent any appreciation in the yen. Emerging market and commodity currencies have resumed their outperformance after a brief bout of weakness in mid-March. The strength of emerging market currencies and associated capital flows has caused problems for the countries concerned, and ultimately a normalisation of the ultra-low rates in the major developed markets is necessary to redress the balance.

## ■ Coronation Africa Frontiers

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Oct 08	7.21%	–	–	20.00%
Benchmark		3.37%	–	–	3.69%

*Annualised, quoted in USD*

With two civil wars erupting, Egypt and Tunisia undergoing revolutionary regime changes, and closer to home, Mugabe pushing for expropriation across our border, it has been a 'very interesting' start to the year.

While the fund returned -5.5% for the period, underperforming our hurdle, we feel that matters might well have been worse. The portfolio carries a large portion of defensive positions, which served to protect the portfolio to a large extent.

Clearly investing in Africa carries additional risks to those which investors typically encounter in more developed markets. On this subject, we direct readers to page 14.

In Zimbabwe, the ruling ZANU-PF has been pushing ahead with the controversial Indigenisation and Economic Empowerment Act (The Act). A hard-line position and desperate timeline has negatively impacted the price of Zimplats, a large holding in the fund.

Zimplats is a world-class asset and one of the lowest cost producers of platinum group metals (PGM) in the world. Its reserve base is unrivalled and it is very clear to us that had this asset been located in South Africa and not Zimbabwe, it would be trading at multiples of its current share price. The Act was originally gazetted on 7 March 2008 and signed into law on 17 April 2008. The Act provided for all companies operating in Zimbabwe to arrange for 51% of their shares or interests therein to be owned by indigenous Zimbabweans. Implats (which owns 87% of Zimplats) has made numerous concessions to government over the past few years, including the surrendering of land and investment in social development projects, in return for empowerment credits. The agreement was that these credits could be offset against the 51% requirement. The concessions and a potential equity empowerment deal have already been factored into our valuation. So what has changed over the last few weeks?

More recently new details specific to the mining sector were published, largely confirming the principles of the Act. The timing for implementation has been significantly reduced. No mention has been made of government honouring existing agreements. The value of shares to be disposed will be calculated based on a valuation agreed between government and the company, which could potentially be very subjective. In summary, there is a scenario where investors may lose 51% of their shareholding in a short space of time. We would argue that based on the balance of probabilities, the odds are in favour of those investors who are prepared to take a longer-term view.

The current forward multiple of Zimplats is 6 to 7 times earnings (price has been volatile). Earnings are significantly below normal, and production is being ramped up despite the uncertain environment. Should no credit be awarded for previous agreements and the worst case scenario is realised, the business on normalised earnings would still trade on just north of 10 times earnings. This is still an attractive price for a producing mine sitting on the largest low-cost platinum reserve in the world. It will be a bumpy ride, no doubt, but we believe valuation is on our side. 🍀



# Guest contributor

After many years of investing in Japan on behalf of Cazenove and Foreign & Colonial respectively, Stephen Morant and Ian Wright joined forces to start Morant Wright in 1999. As a specialist Japan manager, Morant Wright has established a solid investment track record and currently manage \$3 billion on behalf of a diverse range of clients. Their unique approach to investing and reputation has allowed the partnership to flourish, attracting further Japan specialists Tom Mermagen, Richard Philips, Andrew Millward and Dennis Clough over the years. Together they seek out undervalued companies across all market caps where balance sheet strength will be a foundation for future value generation. Morant Wright manage our core Japan exposure in all our long only fund of funds.

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## CF Morant Wright Japan Fund

The generally improving trends of the last few months came to an abrupt and tragic end with the Tohoku Pacific earthquake on 11 March. Not only was it the largest earthquake ever to hit Japan, but the ensuing 30 foot tsunami caused an enormous amount of devastation to the northern part of Honshu. Tokyo was also badly shaken by the earthquake but virtually no damage was sustained. An added complication has been the problems experienced at the Fukushima nuclear plant, which remain unresolved.


It is a huge disaster in terms of human loss but the authorities have been both quick and expansive in their support for the economy; the Bank of Japan poured liquidity into the banking system and immediately doubled its asset purchase scheme. The budget has passed and a supplementary budget is expected soon. There was also coordinated G7 intervention in the currency market as the yen rose to a record level of 76.25 against the US dollar on subsequently unfounded fears of repatriation of overseas assets.

The Prime Minister and his cabinet have been very visible throughout this crisis. The government estimate reconstruction efforts to cost between ¥16 trillion and ¥25 trillion, which compares with ¥10 trillion for the Kobe earthquake. In economic terms Tohoku is not a particularly important area, but some factories have suffered damage which may disrupt supply of components. The effect on domestic insurance companies is likely to be small as most of the cost will be covered by the government or foreign insurance companies.

The economy had been continuing to recover, as demonstrated by February's encouraging data: unemployment fell from 4.9% to 4.6%, retail sales were up 0.1%, exports rose by 9% and factory orders, in January, grew by 4.2%. All has now changed and there will be a significant fall in GDP in the short term.

There have been few results but several other announcements of corporate activity this quarter. Hitachi Transport has made a takeover bid for Vantec and Kansai Paint now has over 90% acceptances for its bid for South Africa's Free World Coatings, although the bid has now been referred to the competition commission. Fujifilm is to acquire Merck BioManufacturing Network for ¥40 billion.

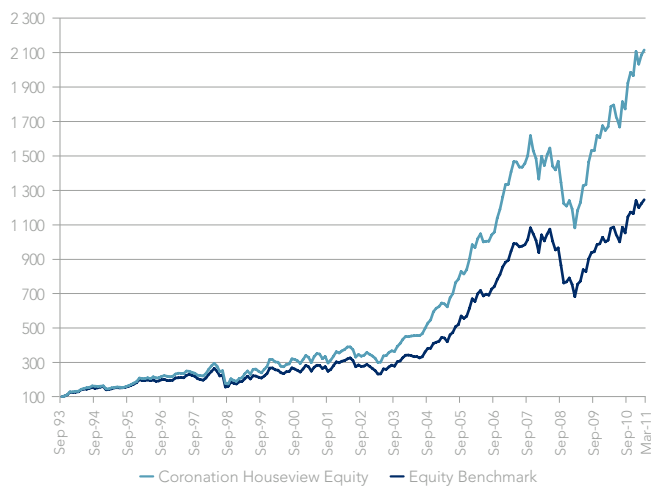
TOPIX fell 16% in the two days following the earthquake, but by month-end had recovered somewhat to finish down 8.6%. Obvious questions remain about the Fukushima nuclear plant and the impact of electricity shortages. Corporate results to be announced in the coming months will be adversely affected by the huge disruption and forecasts are likely to be excessively cautious, but earnings for the year to March 2013 may not be too different from brokers' original estimates.

Economists expect Japan to recover lost ground as reconstruction begins in the second half of the year, and the earthquake may be the event that galvanises the government and the people of Japan into action. This possibility and the cheapness of the market could be the reason for the near record level of foreign buying seen in the week following the quake. Taking a longer term view our portfolio certainly looks very inexpensive on an average price to book of 0.7. 

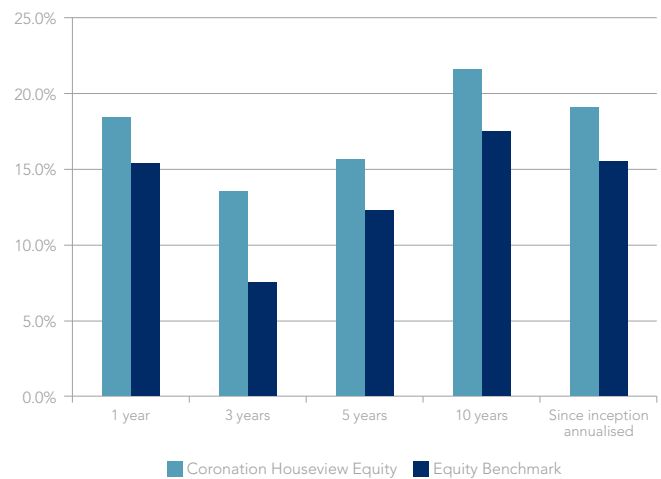
CORONATION HOUSEVIEW EQUITY RETURNS VS EQUITY BENCHMARK

5-YEAR ANNUALISED RETURNS	CORONATION HOUSEVIEW EQUITY	EQUITY BENCHMARK	ALPHA
1998	8.15%	6.49%	1.66%
1999	14.23%	10.91%	3.33%
2000	10.93%	7.52%	3.41%
2001	10.95%	9.38%	1.57%
2002	9.46%	7.14%	2.32%
2003	18.02%	13.49%	4.53%
2004	14.12%	9.35%	4.78%
2005	23.35%	18.63%	4.72%
2006	28.38%	23.07%	5.31%
2007	33.79%	29.52%	4.28%
2008	23.36%	19.28%	4.09%
2009	22.23%	19.77%	2.45%
2010	18.55%	15.12%	3.42%
4 years 3 months to March 2011	12.94%	9.27%	3.67%
<b>ANNUALISED TO 31 MARCH 2011</b>			
1 year	18.4%	15.4%	3.0%
3 years	13.6%	7.4%	6.2%
5 years	15.7%	12.2%	3.5%
10 years	21.7%	17.5%	4.2%
Since inception in October 1993 annualised	19.1%	15.5%	3.6%
Average outperformance per 5-year return			3.54%
Number of 5-year periods outperformed			14
Number of 5-year periods underperformed			–

CUMULATIVE PERFORMANCE



ANNUALISED RETURNS SINCE INCEPTION



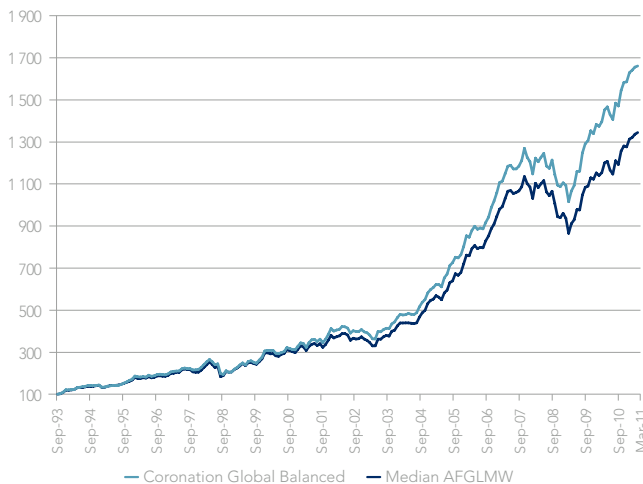
An investment of R100 000 in Coronation Houseview Equity on 1 October 1993 would have grown to **R2 120 888** by 31 March 2011. By comparison, the returns generated by the Equity Benchmark over the same period would have grown a similar investment to **R1 246 445**.



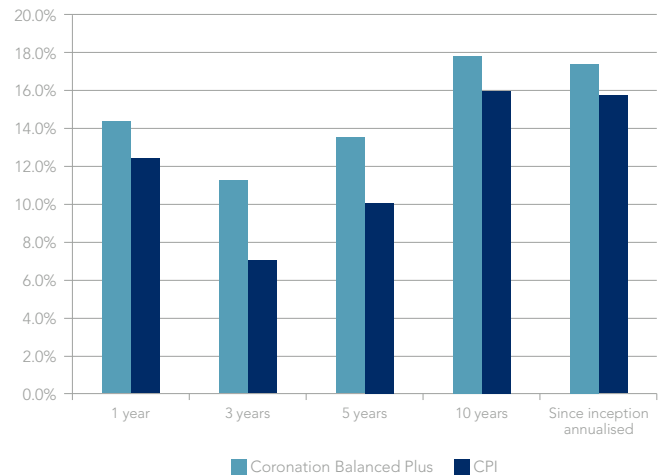
## CORONATION GLOBAL BALANCED RETURNS VS PEER MEDIAN\*\*

5-YEAR ANNUALISED RETURNS	CORONATION GLOBAL BALANCED	PEER MEDIAN	ALPHA
1998	11.21%	11.26%	-0.04%
1999	16.36%	15.54%	0.82%
2000	13.82%	13.17%	0.65%
2001	16.54%	15.02%	1.52%
2002	12.74%	12.05%	0.69%
2003	17.67%	15.96%	1.71%
2004	14.35%	13.30%	1.05%
2005	19.58%	18.16%	1.42%
2006	20.74%	19.53%	1.21%
2007	24.93%	24.81%	0.12%
2008	18.96%	17.47%	1.49%
2009	18.28%	15.15%	3.13%
2010	15.23%	11.66%	3.57%
4 years 3 months to March 2011	11.20%	7.31%	3.89%
<b>ANNUALISED TO 31 MARCH 2011</b>			
1 year	14.4%	12.5%	1.9%
3 years	11.3%	7.1%	4.2%
5 years	13.6%	10.1%	3.5%
10 years	17.8%	15.9%	1.9%
Since inception in October 1993 annualised	17.4%	15.7%	1.7%
Average outperformance per 5-year return			1.52%
Number of 5-year periods outperformed			12
Number of 5-year periods underperformed			1

CUMULATIVE PERFORMANCE



ANNUALISED RETURNS SINCE INCEPTION



An investment of R100 000 in Coronation Global Balanced on 1 October 1993 would have grown to **R1 665 107** by 31 March 2011. By comparison, the median return of peers over the same period would have grown a similar investment to **R1 347 675**.

\*\* Peer Median is the median of the fully-discretionary retirement fund portfolios of the largest managers as published in performance surveys and calculated by Coronation Fund Managers.

**INSTITUTIONAL FUND PERFORMANCE**

FUND <sup>Δ</sup>	FEES <sup>°</sup>	LAUNCH DATE	1 YEAR	3 YEARS	5 YEARS	CUM SINCE LAUNCH <sup>†</sup>	ANN SINCE LAUNCH <sup>†</sup>
<b>GLOBAL BALANCED</b>							
Houseview	G	01-Nov-99	14.52%	11.40%	13.63%	525.92%	17.43%
Peer Median*			12.47%	7.09%	10.08%	430.73%	15.74%
Managed	G	01-Apr-96	15.56%	12.62%	14.54%	1064.74%	17.78%
Peer Median*			13.32%	8.71%	11.71%	697.16%	14.84%
<b>DOMESTIC BALANCED</b>							
Domestic Houseview	G	01-Mar-04	18.32%	13.75%	15.12%	287.99%	21.10%
Peer Median*			14.18%	9.85%	11.95%	232.59%	18.49%
<b>SPECIALIST EQUITY</b>							
Core Equity	G	01-Mar-04	18.85%	13.80%	16.32%	362.36%	24.13%
FTSE/JSE Shareholder Weighted Index			15.38%	7.41%	12.22%	278.06%	20.65%
Houseview Equity	G	01-May-00	18.41%	13.59%	15.73%	663.41%	20.47%
FTSE/JSE Shareholder Weighted Index <sup>1</sup>			15.38%	7.41%	12.81%	432.65%	16.56%
Aggressive Equity	G	01-Jan-04	20.10%	15.99%	16.51%	380.36%	24.17%
FTSE/JSE Shareholder Weighted Index			15.38%	7.41%	12.25%	293.54%	20.80%
<b>SPECIALIST FIXED INTEREST</b>							
Institutional Cash	G	01-Sep-06	7.37%	9.62%	–	51.95%	9.56%
Short Term Fixed Interest 3-month Index			6.18%	8.49%	–	47.23%	8.81%
Active Bond	G	01-Jul-00	9.96%	11.19%	8.28%	263.59%	12.76%
BEASSA All Bond Index			8.34%	10.13%	7.25%	238.35%	12.01%
Strategic Bond	G	01-Jun-08	10.14%	–	–	43.87%	13.70%
BEASSA All Bond Index			8.34%	–	–	38.01%	12.04%
<b>INFLATION-LINKED BENCHMARK PORTFOLIOS</b>							
Global Absolute	G	01-Aug-99	12.95%	12.99%	13.53%	615.80%	18.38%
CPI + 6% p.a.			10.01%	12.33%	12.89%	294.35%	12.48%
Domestic Absolute	G	01-Apr-02	16.05%	15.93%	14.93%	416.20%	20.01%
CPI + 5% p.a.			9.01%	11.33%	11.89%	158.16%	11.11%
Inflation Plus	G	01-Oct-09	13.48%	–	–	21.89%	14.10%
CPI + 3.5% p.a.			7.51%	–	–	11.51%	7.54%
Medical Aid Absolute	G	01-Apr-04	13.70%	13.56%	13.17%	199.60%	16.97%
CPI + 3% p.a.			7.01%	9.13%	9.99%	81.58%	8.90%
<b>HEDGE FUNDS</b>							
Coronation Presidio Fund	N	01-Oct-05	19.81%	18.46%	16.28%	133.27%	16.65%
Cash + 7%			12.91%	15.34%	15.66%	120.94%	15.50%
Coronation Multi-Strategy Arbitrage Fund	N	01-Jul-03	11.04%	14.57%	14.56%	191.43%	14.80%
Cash + 5%			10.91%	13.34%	13.66%	163.68%	13.33%
Coronation Granite Fixed Income Fund	N	01-Oct-02	9.39%	11.67%	11.03%	154.68%	11.63%
Cash + 3%			8.91%	11.34%	11.66%	156.29%	11.71%
<b>OFFSHORE FUNDS<sup>2</sup></b>							
Global Equity FoF (US\$)	N	01-Jul-00	14.14%	4.59%	4.50%	48.87%	3.91%
MSCI World Index (US\$)			14.03%	0.34%	2.64%	19.06%	1.64%
Global Equity Alternative Strategy FoF US\$ <sup>3</sup>	N	01-Aug-96	6.99%	3.36%	3.47%	264.36%	9.22%
50% MSCI World Index + 50% USD Cash (US\$)			8.76%	0.68%	3.96%	104.62%	5.00%
Coronation Global Managed	G	01-Mar-10	9.96%	–	–	12.43%	11.42%
60% MSCI World Index + 40% Citigroup World Government Bond Index (US\$)			11.63%	–	–	15.06%	13.82%
Global Capital Plus (US\$) <sup>4</sup>	G	01-Sep-09	9.03%	–	–	18.35%	11.22%
50% 3-month USD Libor + 50% 3-month Euro Libor (US\$) + 1.5%			4.83%	–	–	3.05%	1.92%
Global Bond (US\$)	G	01-Oct-09	8.90%	–	–	7.07%	4.66%
Citigroup World Government Bond Index (US\$)			7.29%	–	–	3.82%	2.53%
Global Emerging Markets	G	14-Jul-08	21.40%	–	–	46.01%	14.76%
MSCI Emerging Markets Index (US\$)			18.78%	–	–	20.11%	6.99%
Africa (US\$)	G	01-Aug-08	15.37%	–	–	54.02%	17.58%
3-month USD Libor + 2.5%			2.87%	–	–	9.21%	3.36%
Africa Frontiers (US\$)	G	01-Oct-08	7.21%	–	–	57.75%	20.00%
3-month USD Libor + 3%			3.37%	–	–	9.47%	3.69%

<sup>Δ</sup> Figures are quoted from the Independent Retirement Fund Survey as at 31 March 2011.

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

<sup>2</sup> Figures quoted in US\$ as at 28 February 2011, with estimates for March 2011.

<sup>3</sup> This fund is available to institutional investors only.

<sup>4</sup> Formerly known as Global Latitude.

<sup>°</sup> G = Gross, N = Nett

<sup>†</sup> CUM SINCE LAUNCH = Cumulative returns since launch, ANN SINCE LAUNCH = Annualised returns since launch. Figures of one year and less indicate percentage change.

\* Peer Median is the median of the fully-discretionary retirement fund portfolios of the largest managers as published in performance surveys and calculated by Coronation Fund Managers.

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