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The Coronation Fund Managers Institutional Quarterly

July 2011

CORONATION
FUND MANAGERS

Notes from my inbox

by **KIRSHNI TOTARAM**

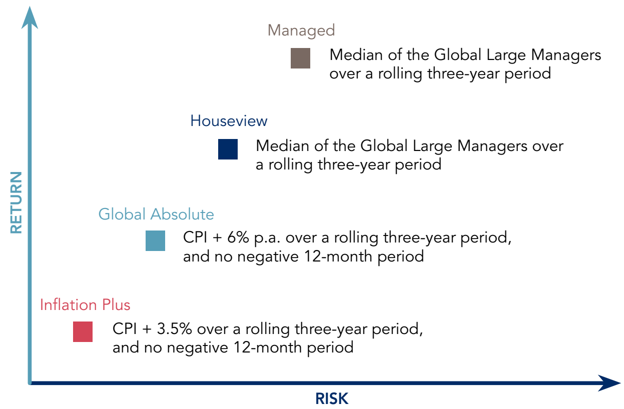
***KIRSHNI TOTARAM** heads up the institutional business and is a member of the executive committee. She is a qualified actuary and a former manager of the Coronation Property Equity Fund.*

This has once again been a volatile and news filled quarter. Not only have global markets kept investors firmly on their toes 'playing them between the risk-on-risk-off trade' – but regulatory changes in the local market have also taken a lead role. The new Regulation 28 has finally been promulgated with increased freedom and flexibility; once again raising the tactical asset allocation debate of whether the decision should rest with the board of trustees and their consultants, or be outsourced to the asset manager, either in part or fully, within mandated terms. From our perspective, we continue to see lots of interest on the subject as many mandates return to actively managed global multi-asset class solutions. That said, many critics remain – citing numbers that show the majority of managers to have added no value through asset allocation over the past 10 to 15 years, and that any value generated has been through security selection alone. We have long disputed this fact and continue to do so. One of the biggest reasons that historic analyses of return numbers against historic quantitative benchmarks show little value add through asset allocation, is because the benchmarks have typically had a weighting of around 75% in equities. What this means is that the manager was unable to overweight equities (due to regulatory limits) – the highest beta asset class and arguably the asset class with the greatest potential for stock selection alpha. Coronation's numbers continue to show value add in both these areas – although our bottom-up, valuation-driven approach to investing does typically combine the asset allocation and security selection decision. But enough said on that – we will explore some of these themes and more in our August roadshow titled 'Making Sense of the Noise', where you will hear from CIO Karl Leinberger and long-time industry stalwarts Charles de Kock and Mark le Roux.

In May we gave notice to investors of our SA equity mandate closure as at 31 March 2012 to new institutional clients. This closure in no way impacts the day-to-day operations of existing clients as it applies solely to new clients. For full details please see Karl Leinberger's article on page 8.

Another significant change over the quarter was the merging of the Coronation Managed II portfolio into the Coronation Managed portfolio with effect from 30 June 2011. The rationale behind this move was to simplify our multi-asset class offering to one aggressive balanced fund. We have also adjusted all the benchmarks of our global balanced funds to allow for the changes to Regulation 28 and the increased offshore allowance. Our multi-asset class range now looks as follows:

RISK PROFILING CORONATION'S GLOBAL BALANCED FUNDS

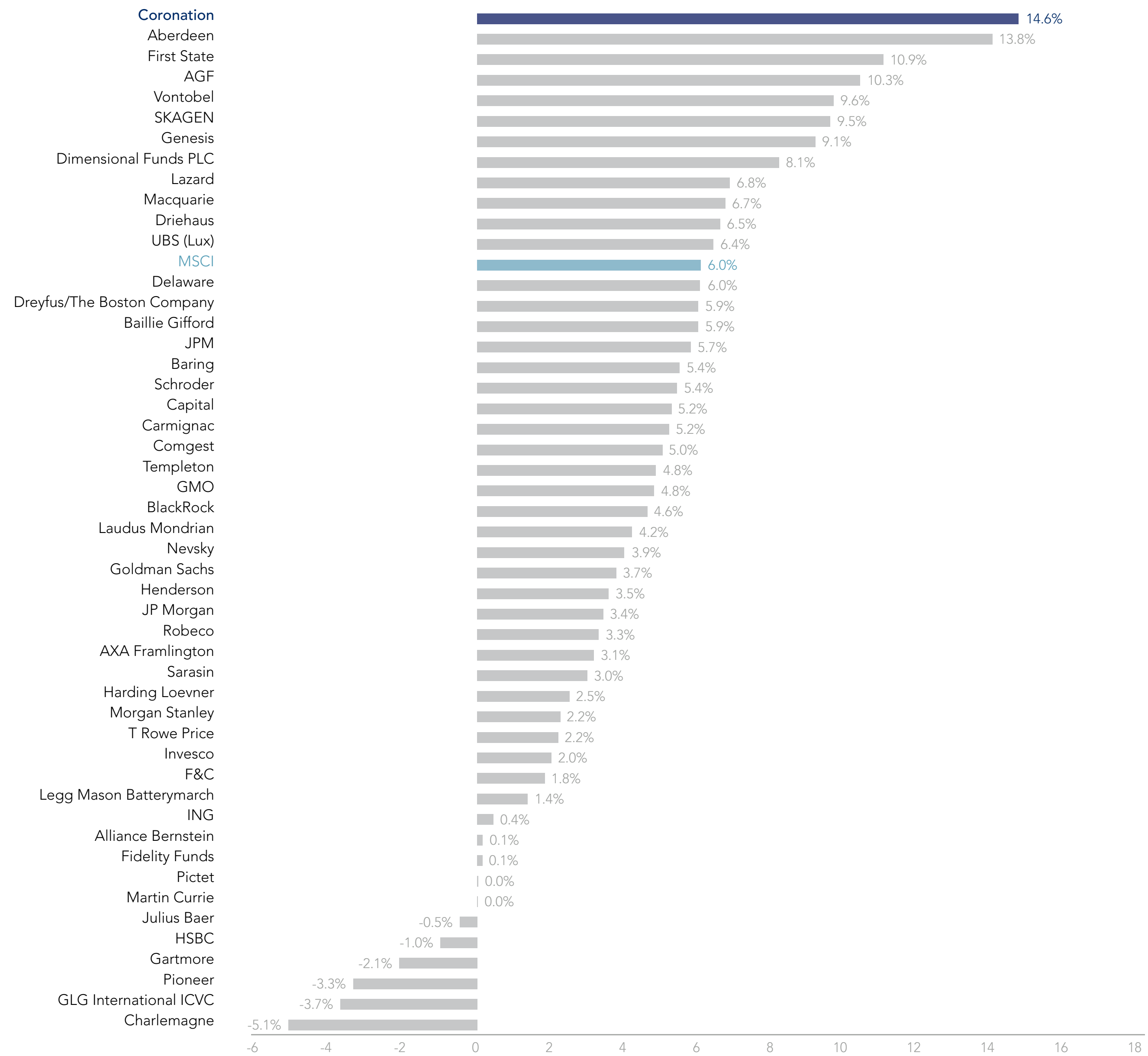


We continue to attract much interest and support in our global funds, and are pleased to announce that the Coronation Global Emerging Markets Fund recorded its three-year anniversary on 14 July 2011. This fund was launched into the eye of the financial crisis and resultant market meltdown, and has produced an annualised alpha of 8.5% versus the MSCI Emerging Market Index since inception. To provide context to this world class fund, we show below the performance of the fund alongside the biggest emerging market peers in the world.

In this quarter's issue Stephen Peirce covers the ongoing sovereign debt crisis in Europe on page 12 and on page 21 Tony Gibson talks about the impact of a tough market environment on the psyche of international fund managers. In a similar vein, Pieter Koekemoer covers the issues of policy uncertainty within the South African context on page 5.

Despite the economic malaise in the developed world, global assets have comfortably outperformed local assets in the first half of 2011. At the time of writing, our international unit trust funds have produced rand returns in the 7% to 10% range year to date, while our local growth-oriented funds returned between 0% and 5%. Tax remains a topical subject of conversation with the recent release of the Revenue Law Amendment Bill. The good news here is that there is now a lot more clarity on how dividends will be taxed in future, making non-redeemable preference shares much more attractive to untaxed investors such as pension funds (read more on page 10).

CORONATION GLOBAL EMERGING MARKETS FUND VS. 50 GEM PEERS SINCE INCEPTION (ANNUALISED) ENDING 30 JUNE 2011



Policy changes that will shape our future

by **PIETER KOEKEMOER**

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

The investment environment in South Africa has been supported by a remarkably stable and consistent policy environment, both at macro and micro levels, over the past decade. This high level of policy predictability led to increased certainty which supported market confidence and created an environment in which it was possible for local capital markets to produce exceptional returns. However, most things are cyclical and periods of confidence and stability are inevitably followed by moments of change and increased uncertainty.

Due to a combination of global and local factors, many facets of historical policy decisions are currently under scrutiny. The primary rationale for a change in approach is the scars left by the global financial crisis in 2008. The impact of the crisis is pervasive, varying from lower economic growth and significant job losses in SA over the past three years to diminished trust in the global financial services industry and its regulators. Many of the new ideas and events that will shape our future has its roots in the global credit binge of the 2000s, the Armageddon moment in 2008 and the slow and painful deleveraging process we are living through at the moment.

The exploration of new policy directions will lead in some cases to fundamentally different approaches, which could impact the efficiency of the local economy in general and the operation of capital markets and its participants specifically. As a long-term focused investment business our interest in this process is to ensure that we can continue to deliver the best possible returns for our clients over time. We believe that reasonable outcomes are more likely to be achieved through constructive dialogue that focuses on identifying the best approach for SA while remaining mindful of balancing the costs and benefits of proposed market interventions. Coronation is actively participating in many of these debates on behalf of clients.

Some of the key areas currently under discussion are summarised below.

- The National Planning Commission (NPC) recently released its diagnostic report for discussion before finalising a development plan for SA through 2030.
- Government released its New Growth Path (NGP) framework in November last year as a replacement for their previous economic frameworks AsgiSA and GEAR.
- A National Health Insurance (NHI) scheme, which aims to extend healthcare delivered by a provider of choice to all citizens at no, or limited, cost to the user is intended to be implemented gradually over the next 14 years.
- National Treasury released a discussion paper 'A safer financial sector to serve SA better' which deals with reforms and extends to the way in which financial sector activity will be regulated.
- A further discussion paper on introducing a National Social Security Fund and reforming the retirement industry is expected later this year.
- Many aspects of the tax code relating, among others, to the taxation of dividends, interest, life insurance products, retirement savings and derivatives are either in the process of being changed or the subject of ongoing discussion.

Macro reforms

Both the NPC and the NGP have identified the elimination of poverty and the reduction of inequality as key policy objectives, with reducing youth unemployment and improving educational outcomes as the key objectives. Achieving these objectives is imperative to the long-term wellbeing of SA. The NGP also envisages a greater level of investment by the formal savings industry in the infra-structure necessary to support economic growth into the future. If this policy objective is implemented well, it could lead to deeper and wider capital markets (increased liquidity and more investment instruments), offering more opportunities to investors to enhance their returns and/or reduce their risk. If implemented poorly, specifically in the form of prescribed investments not subject to market pricing, it could be viewed as a stealth tax on capital.

The proposed implementation of NHI is arguably the most ambitious entitlement programme launched in the democracy era. While the objective of enhancing health outcomes for all is laudable, the practical and cost implications are significant. Consulting firm Econex believes that this system will add around R100 billion to annual government expenditure, and take healthcare spend from 4% of GDP to 8.5% over the next 14 years. At least some of this additional cost will have to be funded through the tax system, most likely through an increase in personal income tax, and decreases in the tax incentives available to support private healthcare and pension savings. This initiative will cause a reversal of the reduction in personal income tax rates experienced over the last decade, which will force investors to save more to achieve the same after-tax outcomes.

Financial sector reforms

The past focus of financial sector policy reform since the global financial crisis in 2008 has been on improving financial stability. This culminated in the Basel III and Solvency II processes aimed at strengthening the capital requirements applicable to banks and insurance companies respectively.

The current reform agenda is starting to focus more on changing the way in which the conduct of financial services providers is regulated. The key change in global thinking about regulating the financial services sector involves a move from a 'light-touch' to an 'intrusive' regulatory approach. The current 'light-touch' approach relies primarily on a disclosure and complaints driven approach, while a more intrusive approach will add more proactive regulatory interventions. While this more intrusive approach will enhance consumer protection, the risk is that its benefits may be outweighed by the additional costs incurred in policing the system.

The key market conduct initiative announced by Treasury is the implementation of a formal 'Treating Customers Fairly' (TCF) programme, which is intended to enhance market oversight. This programme, expected to be implemented formally from 2014, will be the first consistent consumer protection framework to apply to all types of financial products. The core principle underpinning TCF is to ensure that all companies operating in the financial services industry embrace a culture of putting customers first: by communicating relevantly and regularly, providing products specifically designed to meet client needs and explaining clearly what clients can reasonably expect from these products.

Retirement reforms and social security

SA has a well-developed retirement system, with an asset base that compares favourably to other countries at a similar stage of development. However, its design and architecture can be improved to better serve the needs of more South Africans. Learning from pension reform initiatives in many parts of the world, government has launched a formal retirement reform process to achieve the following objectives:

- Increase coverage and access, as only around 6 million of SA's 13 million employed labour force are currently members of retirement funds.
- Enhance social solidarity by enabling the needy to benefit from the protection of the majority.
- Improve efficiency through ensuring that benefits are not eroded by unnecessarily high fees.

- Ensure sustainability by keeping benefits affordable and simple enough to ensure that fund members understand the value thereof.
- Achieve adequacy through enhancing SA's saving culture and improving the level of retirement provision made by individuals.

Government's discussion document on retirement and social security reform expected later this year will give a clearer indication on how they believe the above objectives can best be achieved. For us, our focus remains on ensuring that pre-existing rights are protected in the event of significant changes to the existing system and that the implementation and transition risk of systemic changes are minimised.

As a member of Asisa (the Association for Savings and Investment South Africa), Coronation is supportive of a number of industry proposals designed to match government's objectives, industry's capacity and the needs of our clients. These proposals include:

Coverage and access objective: implement a gap fund

The creation of a gap fund that provides access to both formal and informal sector workers by using existing industry infrastructure to achieve cost efficiencies. The fund can be developed and implemented quickly and will require minimal legislative changes to achieve successful launch. The proposed fund design allows for significant policy flexibility and is loosely based on the successfully implemented Fundisa education savings scheme (a public-private partnership between industry and government). The gap fund presents a viable default option if a mandatory savings regime is implemented, somewhat similar to the National Employment Savings Trust scheme recently introduced in the UK. A key benefit of the fund is that it will achieve 'coverage and access' without major implementation risk as it will cause no significant disruptions in the existing pension system.

Social solidarity objective: risk subsidy mechanism and standardised annuity

Ensuring equalised, standard-rated minimum death and disability benefits for all workers is at the heart of achieving enhanced social solidarity. Considerable research has been done on the concept of a risk subsidy mechanism that can be used to equalise benefits across funds with different member risk profiles through transfers from lower risk to higher risk schemes. The design limits moral hazard by recommending technical rather than actual risk experience, to incentivise schemes and employers to actively manage risk through, for example safety and healthcare programmes. Equity in the system may be further enhanced through the introduction of a standardised annuity to provide better value for lower earners.

Improve efficiency objective: ensure adequate economies of scale

A comprehensive review of costs in the retirement industry confirms that the rapid consolidation in the industry – from more than 13 000 funds a few years ago to 3 200 at present – is driving increased economies of scale. It also shows that SA's large standalone pension funds and retirement annuity funds are very cost-effective by international standards. Large standalone funds on average incur costs of less than R38 per member per month. Inefficiencies are not only a factor of scale – complexities in the tax, benefit administration, contribution collection cycle, and fund rules all need to be addressed through policy intervention to enhance system efficiency.

It is clear that the scope of potential changes to the environment in which we invest on your behalf has broadened significantly, requiring us to engage more intensely with regulators and policymakers. While we will play an active role in protecting the 'commons' we all rely on, we remain convinced that by sticking resolutely to our philosophy of focusing on finding long-term value while ignoring the short-term noise, we will continue to deliver on our most important responsibility of producing superior investment returns for all our clients.

Equity closure

Demonstrating our commitment to put clients first

by **KARL LEINBERGER**

KARL LEINBERGER is CIO and a member of the executive committee. He joined Coronation in 2000 as an equity analyst, was made head of research in 2005 and appointed CIO in May 2008. Karl co-manages the Coronation Houseview portfolios.

In May we announced that we are closing our Institutional SA Equity product to new clients from 31 March 2012. This is the second time in Coronation's history that we have closed a major product to new clients (the Institutional Absolute Return funds were closed in 2005 for a period of four years). Since genuine asset closes are quite rare in our industry, we have fielded numerous questions from clients in the last few weeks. The challenges and mechanics associated with closing a major product are significant and we have therefore attempted to encapsulate our thinking in question and answer format:

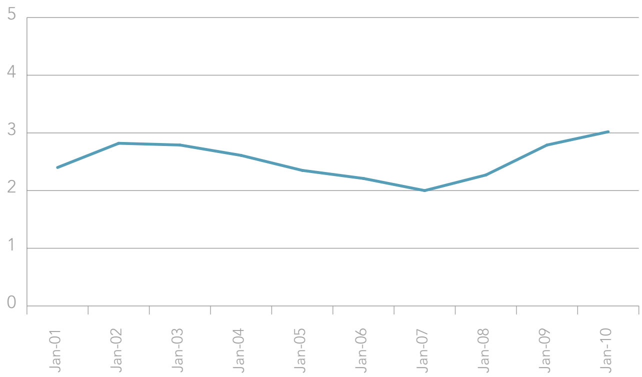
What made Coronation believe it had reached the point at which it should close?

Interestingly enough, our JSE-listed assets under management only represent 3% of the free float of the JSE. This has not grown materially over the last five years. The adjacent graph and table show that the vast majority of our asset growth in recent years has in fact come from the performance of our funds, as opposed to inflows. Notwithstanding, we have decided to close for the following reasons:

- It is a powerful demonstration of our commitment to put clients first. As an independent asset manager, we will amount to nothing if we cannot outperform markets. We are therefore unwilling to risk even getting close to the point at which size impairs our ability to outperform.

- We have always believed that we should close before (as opposed to once) we reach capacity. This allows us to close in a manner that will create the least amount of disruption to our existing clients. We have attempted to get this right by giving nine months warning of the close and by remaining open to cashflows from existing clients.

CORONATION LOCAL EQUITY AS % OF JSE FREE FLOAT



Source: Coronation and I-Net Bridge

FIVE-YEAR ANALYSIS OF CORONATION ASSET BASE (Rbn)

	Opening balance	Net flows	Performance	Closing balance
2010	154.7	11.1	32.1	198.0
		7.2%	20.8%	
2009	125.0	8.1	21.6	154.7
		6.5%	17.3%	
2008	133.7	(4.5)	(4.3)	125.0
		(3.4%)	(3.2%)	
2007	101.4	0.7	31.6	133.7
		0.7%	31.2%	
2006	82.0	1.3	18.2	101.4
		1.6%	22.2%	
Simple average		2.5%	17.7%	

Source: Coronation

Will this close have any impact on existing institutional clients?

Absolutely not. Existing clients will be able to invest and disinvest as they have in the past.

Why are you closing to new institutional clients but not retail (unit trust) clients?

Institutional clients represent the vast majority of our asset base (approximately 75%). Consequently, it is the area where we feel capacity pressures most acutely. It is also the most efficient area in which to achieve a practical close (i.e. we simply stop pitching to new clients). In the retail market it is difficult to close to new clients, given that we do not have a tied distribution network and that most of our flows (approximately 80%) come from investment platforms and other aggregators that do not give us perfect information on the identity of clients behind those flows.

Will this have any impact on Retail clients?

An emphatic, no. For the reasons given above we do not believe it is possible to close our retail business to new clients.

Why did you close SA Equity mandates but stay open to asset allocation mandates?

Capacity pressures are most acute in JSE equities. We believe that we have significant capacity in global equities, emerging market equities, African equities and the interest-bearing asset classes. Closing the asset allocation mandates would therefore deny clients access to asset classes where we currently have no capacity constraints.

We also believe that asset allocation mandates are the most efficient use of our remaining JSE equity capacity. Our performance track record demonstrates our ability to add value through asset allocation and it therefore makes sense to us to use our remaining equity capacity in this manner – adding value to clients at both the stock selection and asset allocation level.

How long do you expect to stay closed for?

We do not believe that we have any ability to forecast the future. The most important considerations in the capacity debate are JSE liquidity and client cash flows. We estimate that the institutional savings pool is shrinking by 10% per annum (excluding market performance). For this reason a fund manager has to run hard to stand still. We therefore expect natural client withdrawals to free up some capacity in the years ahead.

Preference shares

A buy for tax-sensitive investors looking for yield

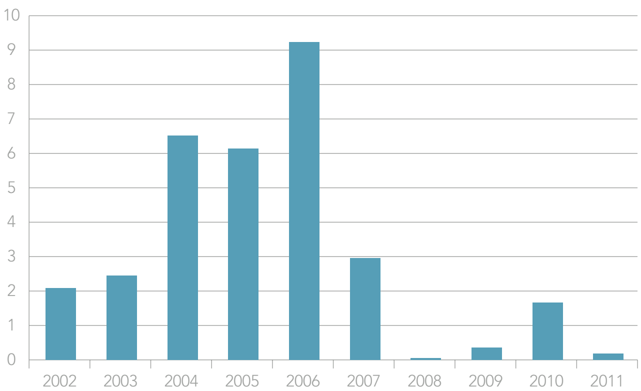
by **KARL LEINBERGER**

When we tell clients that we think preference shares (of the non-redeemable variety*) are a buy, we get varying reactions from surprise to shock. Preference shares are distrusted and almost universally disliked in the retail market. And it shows in the price (i.e. prices are low and yields are attractive).

To understand why this is the case, we need to consider the history of the local preference share market:

- Preference shares were introduced into our market with much fanfare in the early to mid-2000s. They were sold as a tax-efficient instrument that moved 'lock, stock and barrel' with the banking sector's prime interest rate.
- Investors unfortunately then bought into the concept and:
  - took *excessive exposure* to preference shares (see chart 1 which shows the market issuance of preference shares over the last decade);
  - at the *wrong price* (i.e. although the dividends were tax free, investors were buying them at yields that were just too low); and
  - *without understanding* the capital risk that one is exposed to in the instrument.

CHART 1: SA NON-REDEEMABLE PREFERENCE SHARE ISSUANCE (Rbn)

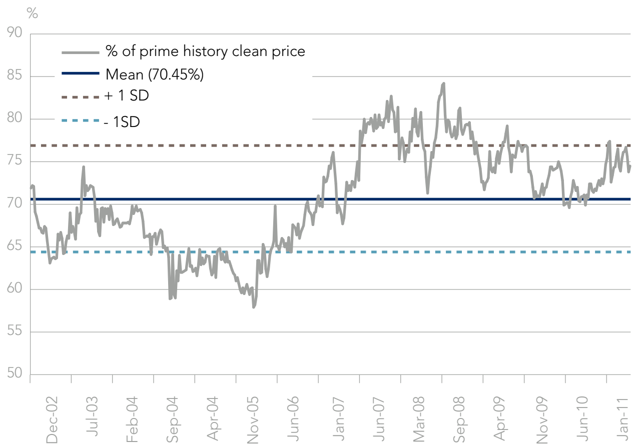


Source: Deutsche Bank

This 'fear and loathing' has created a buying opportunity for the investor that is prepared to put emotion aside and focus on the fundamentals. We believe that preference shares are a great buy for tax-sensitive investors for the following reasons:

- *Yields are very attractive:* a limited appetite for preference shares has resulted in low prices (high yields):
  - *Versus history:* Chart 2 shows the yield offered by the Nedbank preference share, an instrument that has been in issue for much of the last decade and consequently our best proxy for the broader preference share market. The graph shows how expensive preference shares were in the early 2000s (when investor interest was high) and how much cheaper they are today (now that investor interest is low).

CHART 2: % OF PRIME HISTORY BASED ON NEDBANK PREFERENCE CLEAN PRICE

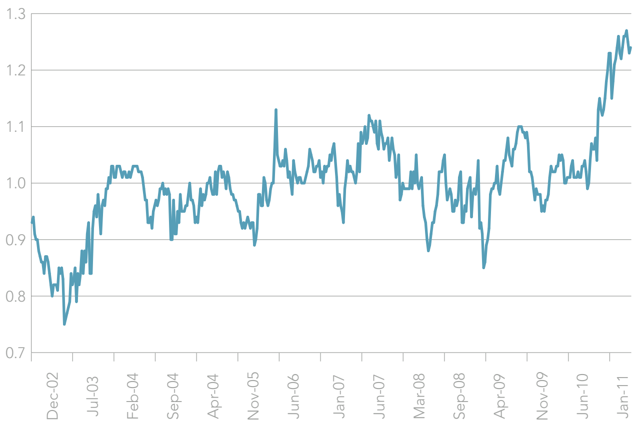


Source: I-Net Bridge, Coronation

  - *Versus other yielding assets:* Chart 3 shows the yield earned on the Nedbank preference share as a percentage of rates Nedbank offers in the money market (as a proxy for overnight cash). This graph clearly illustrates the scale of the opportunity. Preference shares currently offer a higher yield than the money market. Think about that for a second! Dividends on preference shares are presently not taxed (see point below on upcoming changes in tax legislation), while the interest earned in the money market attracts tax up to 40% (once the annual interest exemption has been earned).

* Non-redeemable preference shares (also sometimes called perpetual preference shares) are the only preference share where the issuer has expressly committed to gross up the dividend when the upcoming tax changes on dividends are implemented. Being perpetual in nature, the income is clearly a dividend and unlikely to be classified as interest for tax purposes.

CHART 3: NEDBANK PREFERENCE SHARE EFFECTIVE YIELD/
NEDBANK MONEY MARKET



Source: I-Net Bridge, Coronation

- *The closure of dividend income funds.* Tax-sensitive investors are heavily invested in dividend income funds and when these close in February next year (due to a tightening of the tax legislation) these investors will be forced to look at tax-efficient alternatives.

- *Upcoming changes in tax legislation will be very positive for preference shares.* The changes to our tax system for dividends from STC to one of withholding tax, will take effect on 1 April 2012. The mechanics are quite complicated, but the bottom line is that dividends on non-redeemable preference shares will be grossed up for the withholding tax that investors will now have to pay SARS. For the man in the street this change is tax and cashflow neutral. But pension funds are not subject to the withholding tax, and there is a reasonable chance that the asset class re-rates once pension funds start buying an asset which has become 10% more attractive to them (10% is the dividend withholding tax).

We believe that the opportunity is compelling. It is our experience that you should never allow yourself to feel too comfortable when you are thinking the same as everyone else in the room...

Buy preference shares, not in spite of their de-rating over time but because of it! But remember that nothing in life is for free. Preference shares come with the following health warnings:

- *Credit risk:* They sit lower in the capital structure than debt, so one needs to invest with a Fund Manager that actively manages credit risk on your behalf (inherent in the Coronation Preference Share Fund or any of our asset allocation funds).

- *Liquidity:* Preference shares are illiquid. Although this is not an issue for most investors, those who are investing tens of millions into this asset class need to be aware of this constraint.

- *Capital risk:* Preference shares re-rate and de-rate over time based on demand and supply for the instruments. This exposes investors to capital risk. However, we believe that investors should focus on the percentage of prime at which they bought (consequently secured for the duration of their holding) and ignore the daily mark to markets they will experience on the instrument.

- *Tax risk:* The views in this article are relevant for non-redeemable preference shares only and not the more exotic variations available.

Greece

The gloomy shadow of the Acropolis

by **STEPHEN PEIRCE**

***STEPHEN PEIRCE** joined Coronation as a fixed interest portfolio manager in 2010. He has 16 years' investment experience, predominantly gained at Societe Generale Asset Management and Royal London Asset Management where he managed a wide range of institutional and retail fixed interest products.*

There is no shortage of things to say about the crisis in Greece; after all, the situation remains so fluid that every day something new comes up. The Donald Rumsfelds amongst us could identify many 'known unknowns', speculate on a few 'unknown unknowns', but agree on very few 'known knowns'. The crux of the matter is that so far, there appears to be a lot of liquidity support but very little concrete action in terms of solving the underlying Greek problems which led to the crisis in the first place.

From what we know, the scenario at the time of writing is that:

- The first €110 billion bailout package agreed to in May 2010 by the European Union (EU) and International Monetary Fund (IMF) for the period 2011-2014 is now deemed insufficient for Greece's needs. A second bailout package estimated at €90 billion is on the cards, with the popular view being that some of this money should come through private sector involvement and the balance from the EU and IMF.

- As part of the agreed austerity package Greece is required to respond by contributing a further €30 billion through state asset sales (privatisation), bringing the total to €50 billion.

- The European Central Bank (ECB) has taken an active role in stabilising the banking system since the early days of the financial crisis and continued to do so as the sovereign debt crisis unfolded. The ECB stated in May this year that it would reject Greek bonds as collateral should any forced 'burden sharing' by private investors result in the bonds being rated as in default. But the ECB now finds itself between Scylla and Charybdis (having to choose between two evils): it has lent Greek banks €98 billion secured against Greek government bonds. Removing its support would cause the collapse of the Greek banking system and risk spreading contagion.

European policymakers have been working on a solution, but with the probability of default now estimated by credit default swaps to be in excess of 90%, some 'fancy footwork' will be required. The rating agencies, often criticised for not being proactive, find themselves under immense pressure to delay judgement. ECB officials concede that discussions with the rating agencies are difficult and it looks increasingly likely that some form of compromise will be necessary. The ECB has, after all, already changed its collateral requirements to accommodate Greece (and Ireland and Portugal). In all likelihood it may also have to ultimately accept bonds that are in selective default, with the compromise being that they take a larger 'haircut' (more security is required for a given amount of cash provided).

With the largest private holders being the German and French banks, a 'voluntary debt rollover agreement' was initially sought. This appears increasingly unlikely, with the probability now swinging towards a buyback of debt at market prices through a central European vehicle, most likely the European Financial Stability Fund (EFSF). This vehicle, initially set up to issue bonds to pay for loans to Greece and Ireland, is not currently permitted under its terms of agreement to participate in the secondary market. In order to be used in a buyback programme all 16 member states would be required to ratify the mandate changes at a parliamentary level – something that could take several months. Even then the realistic size of any such buyback programme would be questionable given the EFSF's need to maintain a AAA rating, meaning even if it gets authority to buy back bonds it may not be able to buy enough. In any case, to reiterate – this is more of a band-aid solution, when in fact Greece needs surgery.

Thus we are left depending on Greece to deliver on its obligations; their past record does not inspire confidence.

We look to Greece's history and identify the messages that can be drawn for long-term investors. Bear in mind that government defaults are not uncommon, with defaults occurring on external debt in most geographical regions as recently as the 1980s and 90s. Since 1941, Europe has fared slightly better than other regions with only defaults from Romania (1981 and 1986) and Poland (1981). Greece, however, has defaulted or rescheduled its debt five times since gaining independence in 1829, and has spent 50% of the years since then in a state of default or debt rescheduling[1] . All too often governments have attempted to inflate their debt problems away by boosting money supply or devaluing their currency.

As a result of being locked into the euro, Greece does not have the ability to devalue its currency in order to boost competitiveness. This means it needs to accept real wage cuts to do so – and in conjunction with the austerity measures being implemented to reduce the budget deficit and debt, it is no surprise that citizen anger has swelled into protests.

Investors need to appreciate that the EU and its single currency, the euro, are as much – if not more – about politics as economics. Since the end of World War II, Europe has steadily moved towards greater forms of integration, in part to avoid the rise of extreme forms of nationalism. The EU came into being alongside the Maastricht Treaty in 1993, replacing the previous European Community (1967) and the European Economic Community (1957). The Maastricht Treaty also gave rise to the creation of the euro and a set of convergence criteria which members of a single European currency had to meet. Unfortunately the criteria were never truly adhered to and were all too easily disregarded once entry was gained. In fact, Finland is the only country that currently meets both the 60% gross debt to GDP ratio and the annual debt to GDP deficit limit of 3%.

All too often policy is only made amid a crisis and arguably the events in Greece should not have been allowed to get to this stage. Greece, regarded by many as the birthplace of mathematics, has long struggled to make its numbers add up and there is a history of 'fudging':

- Eurostat publicly expressed doubts about the official figures which led to revised debt figures as early as 2002.
- In 2003, Greece was advised of flaws in the manner in which it estimated revenue collection.
- In 2004, an audit by the then incoming New Democracy government revealed that the 3% hurdle used for euro entry had in fact not been achieved[2].
- Following the election of the Socialist government in October 2009, the 2009 budget deficit was revised from 6% to 8% to 12.7% and then to 15.4% of GDP. In fact, Eurostat has had more issues with how Greece calculates its debt statistics than any other EU member state.

Perhaps most controversial was the revelation that it had entered into swaps with Goldman Sachs in 2000 and 2001 in order to reduce its recorded debt by a total of €2.376 billion. This first came to light in 2003 as did the revelation in 2001 that Italy had made similar trades with JP Morgan dating back as far as 1996. The real issue here is that despite the fact that this was brought to the attention of the ECB and Eurostat, nothing changed until 2008 when several other member states lobbied for a change in the way these transactions were accounted for. So what about the excessive debt procedure and fines for those that failed to adhere to the Maastricht criteria? It seems these were effectively abandoned when the pact was reformed in 2005. So Europe really only has itself to blame for this mess.

1. This time is different Reinhart & Rogoff 2009
2. http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/GREECE/EN/GREECE-EN.PDF

Greece should be seen as Europe's canary in the coal mine. At only 3% of eurozone GDP, Greece is ultimately manageable, but both Spain and Italy are regarded as too big to bail and too big to fail. The EU needs to address its structural issues and somehow establish a firebreak in the event that Greece fails to deliver on its austerity and asset sale programme. Greece today looks very similar to Argentina a decade ago. In the IMF post-mortem[3] of that crisis it concluded that the most viable option would appear to have been an early debt restructuring and abandonment of the currency peg. They also went on to say that the provision of new financing only postponed the inevitable and meant the eventual cost of collapse was all the greater. There are thus worrying implications for the eventual Greece endgame from this analysis.

In the aftermath of the financial crisis governments have been very quick to point fingers and impose new rules on banks requiring them to boost their capital adequacy. They need to heed their own advice: Europe may be in the spotlight, but is far from being the main culprit. Despite the peripheral outliers its total debt burden is lower than both Japan and the US. Both these nations are living on borrowed time. For the current demographics, this means that their debt burdens will deteriorate significantly if nothing is done. Governments may argue that their debt dynamics were compromised by the financial crisis and the transfer of bad debts from the corporate sector. But that merely reflects the consequences of their laissez-faire attitude – an attitude that can be ill afforded at the current juncture. In the past, poor discipline on the part of borrowers would have seen them excluded from markets for a protracted period of time. However, in recent years the fragmentation of the investment community has seen the rise of hedge funds and short-term investors fill vacuums, and even junk-rated borrowers have been able to raise funds at relatively low interest rates. Issuers of debt should nevertheless be wary of relying on the finite resources of these investors. If the number of distressed entities continues to increase, long-term investors are going to demand a lot more certainty before they get involved.

As we go to print US politicians continue to pontificate on the debt ceiling debate. If Europe has one message for the US surely it is 'do not ignore the bond vigilantes'.

3. www.imf.org/external/np/pdr/lessons/100803.pdf

Bond outlook

Meaningful rally in long bond yields unlikely

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.

The US 10-year bond yield rallied by around 50 basis points to below 3% during the quarter. This was driven mainly by the combination of softer economic data released in the US and safe-haven demand for these bonds due to the threat that contagion from the Greek crisis continues to pose to the eurozone. Despite the fiscal woes of a number of European countries, the European Central Bank (ECB) has begun its rate hiking cycle. In April, ECB chief Jean-Claude Trichet hiked short rates by 25 basis points, followed by another 25 basis points in July after signalling 'strong vigilance' with regards to inflationary pressures in the final week of June.

Local bonds have taken their cue from US Treasuries. During the quarter, we have seen the yield on the R186 government bond (maturing in 2026) rally by around 30 basis points to close to 8.5%. Foreign investors have once again returned to the South African bond market and were the main drivers behind the rally. For the month of June alone, foreign investors bought approximately R13 billion worth of South African government bonds. With the rand being relatively stable during the quarter at around R6.80 to the US dollar, and still no sign of rate hikes in the US on the horizon, the carry trade is still alive and well from the foreign side.

Local inflation data continued on its upward trend, passing the midpoint of the South African Reserve Bank's inflation target range in May at 4.6% and 5% in June. Food and energy prices remain the key drivers of inflation and our expectation is that CPI will approach the upper end of the target range of 6% in the final quarter of this year. So far, the Monetary Policy Committee appears reluctant to act on this rising trend in inflation. The rhetoric coming from its members appears to be that they are waiting for second-round effects to manifest in underlying inflation before responding. With the repo rate currently at 5.5% and inflation heading for 6%, negative real short rates towards the latter part of this year appear to be on the cards. Against this backdrop, we still regard inflation-linked bonds (ILBs) – delivering real yields of between 2.5% and 3% – as attractive alternatives in the domestic fixed interest space.

For the quarter, the All Bond Index produced a solid return of 3.9%. This was very much in line with that of ILBs (where one has seen some recent real yield compression) and well ahead of cash which only managed a 1.4% return.

BOND AND MONEY MARKET (LOCAL CURRENCY RETURNS)

Name	June 2011	3 months	6 months	12 months	Year-to-date
All Bond	0.16%	3.9%	2.3%	11.3%	2.3%
GOVO	0.18%	3.8%	2.3%	11.2%	2.3%
OTHI	0.06%	4.5%	2.0%	12.2%	2.0%
Bonds 1 – 3 years	0.54%	2.2%	3.5%	7.8%	3.5%
Bonds 3 – 7 years	0.57%	3.2%	3.2%	9.9%	3.2%
Bonds 7 – 12 years	0.09%	4.0%	2.5%	11.7%	2.5%
Bonds 12+ years	(0.30%)	4.9%	0.8%	12.1%	0.8%
Cash	0.47%	1.4%	2.8%	6.1%	2.8%
Barclays/Absa Govt Inflation-Linked Bonds	0.90%	3.8%	2.0%	10.9%	5.0%
Preference Share Index	2.17%	1.0%	(0.3%)	5.1%	(0.3%)

Source: Deutsche Bank

On the domestic fiscal front, a substantial deficit still needs to be funded. Large weekly government auctions of R2.1 billion fixed-rate bonds and R600 million ILBs continue to take place and this is unlikely to change in the near future. Given the relatively large supply of bonds, coupled with rising inflation and our view that the next move in short rates is likely to be up, it is hard to envisage a further meaningful rally in long bond yields in the near future from current levels.

We continue to favour running shorter duration positions in our fixed interest portfolios and remain invested in ILBs.

MARKET DATA

MARKET MOVEMENTS

Economic group	Qtr 2 2011 %	2010 %
All Share Index R	(0.6)	19.0
All Share Index $	(0.7)	33.0
All Bond R	3.9	15.0
All Bond $	3.8	28.5
Cash R	1.4	6.9
Resources Index R	(5.7)	12.3
Financial Index R	1.3	16.6
Industrial Index R	3.7	27.4
MSCI World $	0.7	12.3
S&P 500 $	0.1	15.1
Nasdaq $	(0.2)	14.2
MSCI Pacific $	0.0	16.1
Dow Jones EURO Stoxx 50 $	2.3	(9.1)

KEY ECONOMIC DATA: HISTORY AND FORECAST

	2008a %	2009a %	2010a %	2011f %	2012f %
HCE	2.2	(2.0)	4.4	4.8	3.7
GCE	4.7	4.8	4.6	4.5	4.8
GFCF	14.1	(2.2)	(3.7)	2.5	6.2
GDP	3.6	(1.7)	2.8	3.6	3.5
Current a/c % of GDP	(7.1)	(4.1)	(2.8)	(4.7)	(5.6)
CPI	11.5	7.1	4.3	5.1	5.6
Prime rate (year-end)	15.0	10.5	9.0	10.0	11.5
R/$ year-end	9.92	7.48	6.81	7.00	7.75
R/EUR year-end	13.44	10.89	9.00	9.80	10.46

Equity market update

Focused on the long term

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.*

News on the global economy over the past quarter has been mostly negative. The US housing market remains weak with house prices continuing to decline. US consumer spending remains sluggish and inflation has edged higher, adding pressure to household budgets. The disappointing economic performance has raised the possibility of a further round of quantitative easing to stimulate economic growth – a scenario that was not even mooted a quarter or two ago.

Furthermore, the eurozone continues to be plagued by sovereign debt concerns. At the time of writing, the Greek parliament voted in favour of a new austerity package. These measures would then enable Greece to receive their next €12 billion aid as part of the first €110 billion bailout package. While a default may have been avoided for now, we believe that this is merely a stay of execution. To date, the market has done a fair job of pricing in a default for a small country like Greece, but not a significant sovereign like Spain, Italy or worse. The implication is that global interest rates are likely to remain lower for longer supporting the pricing of risk assets as capital continues to scour the globe in search of yield.

We increased our equity exposure during the quarter on the back of market weakness and continue to hold close to what we consider a neutral position. Equities remain our preferred asset class for producing superior long-term returns. We remain firm in our belief that global equities offer more value when compared to local equities, particularly in the context of an unsustainably strong rand and therefore remain close to the maximum offshore limit.

The All Share Index delivered -0.6% for the quarter. Industrials led the market with a 3.7% return, while financials returned 1.3% and resources lagged with a -5.7% return. Resource stocks have been poor performers in response to disappointing global economic growth. We used this opportunity to add to the diversified miners, specifically our holding in Anglo American. Despite the relative underperformance, we remain underweight resources given our view that the upside to long-term valuations, based on mid-cycle earnings, is not attractive enough to justify a higher exposure. Our preferred resource exposure remains Sasol which offers good value at 8 times our assessment of normal earnings. We continue to be underweight gold and platinum producers due to our concerns over declining grades and significant cost pressures (labour, electricity and water) faced by these businesses.

Banks recorded -0.9% for the quarter, underperforming other financials. We remain overweight banks given attractive valuations at 9 times our assessment of normal earnings and price-to-book ratios of 1.7 times. We do not hold any of the insurers, with the exception of MMI Holdings. The long-term insurance industry faces numerous regulatory headwinds which will likely make it easier for policyholders to terminate their life insurance policies and create competitive pricing on new product. This would inevitably put pressure on margins. In spite of this, MMI Holdings represents an attractive investment. The merger between Metropolitan and Momentum should allow management to extract meaningful synergies and reduce costs by means of combining the two asset management and health operations. MMI also sits on a significant amount of excess capital that could be returned to shareholders by way of increased dividends or share buybacks. It trades on 8.5 times our assessment of normal earnings and offers an attractive one-year forward dividend yield of 6.8%.

We remain bearish on the inflation outlook and expect CPI to breach the upper end of the South African Reserve Bank's 3% to 6% target band either later this year or early 2012. This view is framed by rising food prices (notwithstanding rand strength), high wage settlements and continued pressure on administered prices all against the backdrop of an accommodative monetary policy. We continue to believe the rand is overvalued and have approximately 59% of our client portfolios invested in rand hedges such as MTN, SABMiller, Naspers and Bidvest.

The share price of SABMiller, one of the biggest positions in our client portfolios, recently came under pressure on the announcement of the proposed bid for Fosters in Australia. Corporate transactions often capture the headlines and can result in volatile share price reaction as arbitrageurs take positions and incumbent investors struggle to digest the new information. Such events can of course present opportunities for those with a long-term inclination. In this case, consensus opinion quickly decided that the company was overpaying, resulting in a stock sell-off. We too did our calculations, and consider it a fair risk that some value may be destroyed by the proposed transaction. Management clearly believe differently and our work suggests a possibility that their positive scenario may unfold. This has left us with a situation where the share price discounted bad news as a certainty, while leaving some chance, even a reasonable one, that the transaction may actually create value. As a result, we added to our holding.

Within industrials, we believe it will be a challenge for the average domestic company to defend its real earnings; a task made more difficult when interest rates are hiked from three-decade low levels. Consequently, we own very few retailers (other than Woolworths and Mr Price) and remain defensively positioned with holdings in the Spar Group and AVI. As highlighted in previous commentaries, we continue to find value in selected small caps with approximately a third of our client portfolios invested in shares outside the ALSI40.

In conclusion, investor behaviour is likely to oscillate between high and low levels of risk appetite, depending on the economic data of the day. In an environment fraught with uncertainty, assets are often mispriced which benefits the valuation-driven, patient investor. We seek to capitalise on these opportunities by setting emotion aside and investing for the long term.

Advtech

Another bite at the cherry

by **SIPHAMANDLA SHOZI**

__SIPHAMANDLA SHOZI__ joined Coronation's investment team in September 2005. His current responsibilities include analysing a range of small cap shares as well as co-managing the Coronation Smaller Companies Fund.

The small cap space is littered with poor quality companies that tend to flourish under favourable economic conditions and struggle, or cease to exist, when the economy tightens up. Typically, companies such as these exhibit a combination of the following characteristics: lack of scale, price takers, inexperienced management teams, weak balance sheets and lack of product diversification. Consequently, the market generally punishes the small cap sector by awarding a discount to its rating relative to the market. So, when we find a small cap that generally displays the opposite characteristics at an attractive price, we get very excited.

Our long-term focus tends to lead us to these well priced little gems at a time when the market is fixated with short-term challenges. Advtech, in our opinion, is one such little gem. While we have been holders of Advtech stock for the past three years, its recent bout of underperformance has given us the opportunity to have yet another bite at the cherry.

Advtech derives the bulk of its earnings from private education and training. While it also has a small well-run recruitment business, we believe its prospects are greatest in the education business. We like the fundamentals of the local private education market. The poor state of public schooling has driven demand for private education by those who can afford it. The problems faced by the country's public schooling system are structural in nature and will therefore take a long time to fix. Hence we believe that demand for private education and training is on a long-term growth trend.

Over the years the sector has recorded impressive growth, with enrolments growing at a compound rate above 20% p.a. since 2002. However, at still only 4% of the total education market in South Africa, it has a long way to go by global standards, which average 13%.

Capitalising on this demand wave, Advtech has strong brands in both the schooling and tertiary sectors of the market. The capital outlay required to build a school is extremely high and it can take a considerable length of time before it operates at optimal capacity utilisation levels. This makes schools as an investment very risky in the early stages. It also creates a significant barrier to entry for new competitors. Once a school is up and running however, the annuity stream derived from fees is fairly predictable and stable. Parents are also very reluctant to move their kids to a different school in tough times, opting first to cut on other discretionary spending. Coupled with the fact that the bulk of income is derived from returning students, schools are in reality very defensive businesses.

Private tertiary institutions on the other hand do not have the same 'certainty' of returning students and spend is more discretionary. This renders them less defensive than schools. That said, their low capital intensity means that they can generate a good return on capital through the cycle. Local players are protected by the regulatory environment which makes it quite onerous to be accredited as a private tertiary institution. Advtech has balanced exposure between the two sectors of the private education market.

The strong demand in the private education market coupled with little supply response has given the private education providers pricing power. Fee increases tend to more than offset inflation in teacher salaries (largest cost). In addition, fees are usually collected upfront while teacher salaries are paid in arrears; giving the education business a negative working capital cycle. This has helped to fully fund the highly capital intensive expansion programme using only internal cash resources. What is even more impressive is that after funding all capital expenditure, Advtech still managed to convert most of its accounting earnings to cash at a 10-year average of 82%.

Growth is predominantly volume driven through increasing capacity in existing campuses or by building new ones. However achieving this balance is not as easy as one might think – too much capacity growth impacts profitability negatively, while too little impacts enrolment growth negatively. Excellent planning systems are essential due to the need to fill capacity immediately, which can take up to three years before coming online. For the best part of the last decade, Advtech's management team has achieved this balancing act very well. However, sometimes even the best planning systems can be slightly off the mark. This was the case in 2010 when additional capacity, which was planned a couple of years prior, was not immediately filled on completion. As such, profit growth was impacted negatively and the share price fell.

Investing with a long-term focus allows us to look through the short term and assess the business based on its normalised earnings. We believe excess capacity will be filled over time which should result in the business returning to normal profitability levels. Our assessment of normal earnings of 60 cents per share is higher than recently reported earnings of 37 cents per share. At current prices the share is trading at a multiple of 9.5 times normal earnings which for a business of such good quality is attractive.

International outlook

The importance of context

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.*

At present, investment markets are in a very unsettled and anxious state, largely due to the increasing number of conflicting statistics and news that they have to absorb on a daily basis. The prevailing uncertainty is well illustrated by a recent survey of the opinions of global fund managers undertaken by UBS. The survey represents 80 institutions managing around $8 trillion and makes for interesting reading. The key observations from this survey are as follows:

- Perceptions are that by far the greatest risk facing the global economy over the next 12 months is that of sovereign default (effectively Greece). Higher commodity prices is the second most worried about issue.

- Participants are mostly disillusioned and cautious about the prospects for global economic recovery and as a result the majority envisage little change to US monetary policy.

- There is no consensus regarding the outlook for investment markets. There is little agreement about the mispricing in capital markets with emerging currencies seen as undervalued by some, while others see commodity prices as too expensive. Approximately 35% of the respondents believe that gold will outperform all other asset classes over the balance of 2011.

- A new observation is that the majority of managers do not expect the US dollar to remain the world's sole reserve currency. Not surprisingly, however, they do not offer an alternative other than a 'portfolio of currencies'.

During May we embarked on one of our regular overseas trips to meet with managers to whom we allocate clients' capital in our Fund of Funds product range. During the meetings – which as always are focused on investment philosophies and the applications thereof – one recurring phenomenon struck us. This was that all managers are suffering from what can be best described as 'Macro Fatigue'. This fatigue has in fact caused our fund managers to actively shield their investment teams from excessive scrutiny and debate around the endless flow of conflicting data points. The belief is that this endless debate and angst will take away their analysts' ability to focus on their core role of finding great investment ideas. It must be remembered that experienced investment managers not only lived through two major equity market meltdowns over the past decade – in 2000 and 2008 – but are also now continually buffeted by emotional hyperbole from the financial press and market commentators. There is clearly no shortage of confusing data being released on a daily basis. However, what seems to be the root cause of the pervasive uncertainty is the lack of clear and sustainable long-term strategies from the global financial authorities that are required to give investors confidence and conviction.

In order to gain some perspective, we need to have a quick reminder of our recent financial history:

- In 2008 the western financial system nearly collapsed under the weight of excess leverage accumulated during the prior 10 years or so. The symptom of this debt was the fact that individuals and financial institutions had borrowed far too much money.

- At the time (in 2008), the clear and sensible prognosis was that the western world needed to go through a prolonged period of financial austerity in order to reduce debt levels and improve balance sheets to sustainable levels.

- This medicine was needed not only for individual consumers but also financial institutions and most western economies.

- However, such was the fear of entering a global depression, that the financial authorities in the US, UK and Europe deemed it necessary to inject unprecedented amounts of liquidity into the financial system. Their logic – which was undoubtedly correct – was that a financial collapse had to be avoided at all costs. Any negative fall-out of these actions could be dealt with at a later date.

- In 2009 financial markets responded in a strong and positive way, reflecting relief at the avoidance of the Armageddon scenario discounted by financial markets in 2008.

We believe that too few investors are currently interpreting the economic news in the context of what happened in 2008. Instead of applying the events of 2008 as the base year, they are worried and disappointed by the fact that growth in the US, for example, is not happily zipping along at the 4% level from 12 months ago. We need to remember that the western world went mad, living far beyond its means in the period building up to the 2008 collapse. The liquidity injections from governments could help avert a financial collapse; but they could not counter a fundamental rule of economics which is that both nations and individuals need to live within their means. Periods of excessive consumption growth fuelled by borrowings inevitably need to be followed by a period of financial deleveraging and therefore lower growth. They need to remind themselves of the financial environment and constraints that we are living under.

The facts at present are:

- The debt bubble that peaked in 2008 will not be unwound and removed in three years. It will in all likelihood take in the region of 10 years to resolve.

- This counts for individual balance sheets as well as national ones. Ireland and Greece are the current symptoms of this as they were the worst offenders.

- The point is that balance sheet repair takes a lot of effort and time. It is therefore extremely unlikely that growth in the western countries can resume the pre-2008 levels of economic activity while this deleveraging process is underway.

- In particular, the US must ultimately start living within its means and move away from a monetary and fiscal policy that borders on recklessness. The long-term implications of this are unclear but it would seem inevitable that the US corporate sector will come under some margin pressure.

- The Greek problem will no doubt grumble on for some time. While it is clear that Greece is insolvent, a restructuring (default) of Greek debt is not an option at present as too many European Banks – many of them German – will have their balance sheets negatively impacted by big Greek write-offs and their solvency brought into question. However, economic sense will prevail eventually as ultimately German voters realise that in reality Germany needs to bail out Germany, rather than merely Greece.

- Investors are currently adjusting to this new paradigm. Unfortunately they are not taking it well as many had come to regard the sharp recovery in 2009/10 as the commencement of a renewed period of robust growth. It was, in reality, merely a short 'high' brought about by the injection of 'liquidity steroids' in 2008/9.

In summary, there is no denying that global macro risks have increased, pushing share prices lower as concerns rise. The conflicting trends reported in recent months are now more apparent in investor perceptions. Growth prospects appear to be worsening globally as petrol prices impact consumption and both employment and housing trends fail to improve. However, as already stated in this article, this must be seen in the context of unrealistically elevated expectations in investors' minds. Looking out a few quarters we doubt that the current slowdown will be long-lasting. In Emerging Markets and China in particular, we would be surprised if growth does not continue to be robust. If growth slows their financial authorities will again loosen monetary policy swiftly.

We continue to believe that larger companies offer materially better prospects on a global basis. Although this approach has not yet added much performance so far in 2011, we are confident that it will. Profits from these global companies should be more insulated than local competitors given their global diversification on both revenues and costs. Meanwhile their attraction to investors in a more difficult liquidity environment should increase given their liquidity, high dividend yields and high level of stock buybacks.

International portfolio update

Coronation Global Equity Fund of Funds

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Jul 00	28.05%	5.52%	5.17%	3.86%
Benchmark		31.19%	1.05%	2.85%	1.66%

Annualised, quoted in USD

The fund returned 0.5% for the quarter, bringing the rolling 12-month performance to 28.1%.

In terms of regional equity performance, Europe was the best performing region, rising 2.9% (in US dollar terms), while North America performed the worst, falling 0.3% (in US dollar terms). Japan was marginally positive at 0.2%, while Asia (excluding Japan) declined by 0.2%. The fund's regional positioning therefore had a positive impact on performance over the quarter.

Manager performance was mixed with the European managers as a group delivering poor performance as the markets reacted negatively to the daily newsflow surrounding the sovereign debt crisis. Morant Wright Japan, however, had a strong quarter, comfortably beating the Topix Index.

Royal Capital had a weak three-month period during which most of their top holdings failed to recover with the market towards the end of the quarter. Royal, however, does not claim to track the index and this comes after a period of relatively strong performance. SEG Great Jones Fund, a consistent performer in our fund, was able to yet again beat the S&P 500 Index this quarter.

The global funds were all marginally positive over the period with the Coronation Global Emerging Markets Fund delivering the best performance.

We expect Europe's sovereign debt crisis to continue rumbling on for some time and the measures that need to be taken will possibly slow down the economic growth. Other factors such as credit and commodities will continue to drive volatility in markets. However, we remain firm in our belief that equity markets provide attractive investment opportunities, particularly the larger, multinational companies that offer diversity, growth and high dividend yields.

Coronation Global Capital Plus

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Sep 09	18.63%	–	–	11.13%
Benchmark		11.40%	–	–	2.63%

Annualised, quoted in USD

The fund returned 2.5% over the past quarter. This is a satisfying outcome given the ongoing financial market volatility and the mere 0.7% return from world equity markets for the period. Global bonds returned a more stable 3.3% return for the quarter, while global listed property returned 4.4%. The fund's 12-month return of 18.6% is equally pleasing and is in keeping with its longer-term objective of producing positive returns at lower than equity market volatility.

The fund's equity holdings had an encouraging quarter – outperforming the MSCI World Index – and over the past two quarters have reversed the negative trend of the previous period. Similarly, the listed property holdings had a good quarter in both absolute and relative terms. Over the last 12 months, the fund's exposure to listed property has contributed materially to performance. The position in physical gold continues to add to performance, albeit less materially than in previous quarters. The fund's fixed interest investments also made a positive contribution to performance over the past quarter as well as over the last 12 months. The only disappointing area of investment was the investment in natural gas. We continue to believe that the demand for liquefied natural gas will support the narrowing of the discount to the price of oil, and as such remain invested in this position.

As mentioned in the previous quarterly commentary we are increasingly optimistic that a positive rerating of Japanese equities will occur. We held this view prior to the recent catastrophe in this country and have not changed our minds since then. Although we are positive on the outlook for Japanese equities as a result of their discount to intrinsic value, we concede that we do not have high conviction as to the timing of a potential narrowing of this gap. With this in mind, we bought 7.5% gross exposure to 10% out-the-money, five-year options on the Topix Index during the quarter. We took advantage of depressed index levels and volatility to get this exposure at a cost of approximately 19 basis points per annum. This gives us the opportunity to gain significant exposure with limited downside.

Largely due to this investment the fund's exposure to equities increased by 4% during the period. There were no other significant transactions. Within the direct equity positions the fund's bias towards defensive businesses remained the same. New positions introduced include BMW, Deutsche Boerse, Deutsche Telekom and Google. Overall, corporate profits in the US and Europe have ballooned in the last two years, company balance sheets are strong, valuations are not stretched on any measures and investor expectations remain low. This creates opportunities, even if volatility persists for a while as the risks of an economic slowdown play out.

There were no changes to the currency exposures of the fund. The bias remains towards the US dollar and away from commodity and emerging market orientated currencies.

Coronation Global Equity Alternative Strategy Fund of Funds

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Aug 96	14.44%	3.57%	4.18%	9.09%
Benchmark		18.49%	0.58%	3.52%	4.89%

Annualised, quoted in USD

The fund's global managers made the largest contribution to overall performance in the quarter. The top performing manager returned 2.2% for the period, driven by good stock picking. The manager's top 10 holdings averaged close to 40% of the fund during the quarter and seven of the top 10 holdings produced positive returns. More importantly, the manager produced a five-year annualised return of 15.5% compared to the MSCI World Index return of 3% p.a. over the same period.

The US managers detracted from overall fund performance. The best performing manager was a new investment made in May 2011. The manager returned 2.3% for the month of May compared to -1.8% from the S&P 500 Index. Six of the manager's top 10 stocks were up for the quarter, with four of these stocks up more than 8.5% each. The other three US managers disappointed during the quarter with below market returns. However, on a five-year basis, they have all outperformed the market.

The European and Asian managers marginally contributed to performance. All four European managers outperformed the MSCI Europe Index, with three of these managers producing positive returns for the quarter. The Asian manager returned 0.3% for the quarter. Two of the European managers have five-year track records over which they have outperformed the market, while the other two managers have three-year track records that are also ahead of the market.

Having invested into a new US manager during the quarter as mentioned above and after redeeming the Asian manager, we now have a total of 11 managers in the fund.

Coronation Global Emerging Markets

	Launch date	1 year	3 years	5 years	Since inception
Fund	14 Jul 08	39.44%	–	–	14.55%
Benchmark		28.17%	–	–	6.01%

Annualised, quoted in USD

The fund continued to perform well in the second quarter of 2011, delivering an alpha of 3.5% compared to the benchmark MSCI Global Emerging Markets Index. This brings its year-to-date alpha to 7.5% and 11.3% over 12 months. Although this performance is pleasing, we believe that both the absolute return and longer-term outperformance are far more relevant for our investors when assessing this fund. Since launching just under three years ago on the eve of a global financial crisis, the fund has produced a compound return of 49.5% compared to the benchmark's 18.9%. This equates to an outperformance of 30.6% or 8.5% on an annualised basis. It will prove very difficult to maintain this level of alpha forever, but if we are able to consistently outperform by 2% to 3% p.a. (after fees) we will create substantial value for our investors over the long term.

The fund's biggest holding remains Great Wall Motors (GWM), a Chinese manufacturer of cars, pick-up and sports utility vehicles (SUVs). At almost 9% of fund, we have increased the position by 2% as the company's share price fell by close to one third during the period. While it has subsequently recovered partially, the underlying volatility reflects the large number of short-sellers of the stock who trade the company as a proxy for China's macroeconomic outlook. In a recent *Corospondent* article (January 2011), we outlined our investment case for this company and continue to hold the view that it offers great long-term potential.

Elsewhere in China we bought Gome Electrical after having sold out of the stock almost two years ago. The company is the largest electrical and white goods retailer in China and continues to add store space to maintain its market share in a fast growing retail sector. Like all retail sectors, scale and volume are key when negotiating prices with large suppliers like LG, Samsung and Sony. Gome should therefore be able to provide lower prices to its customers over time. Management focus has shifted away from growth at all costs to an emphasis on profitable growth and shareholder returns as the market becomes more competitive. It is a strong cash generator and has a large net cash position that makes it very attractive at 16 times earnings.

We added Educomp Solutions, India's largest education solutions provider to the fund in May after a recent trip to the country. Good quality education is highly coveted and private schooling in various guises can cater for all income segments except for the very poor. Unfortunately the quality of teaching leaves a lot to be desired, even in private schools. Educomp developed a content library covering the entire schools syllabus. When this library is installed with the appropriate IT systems and projector, it enables a teacher to graphically illustrate and explain concepts to learners. The additional cost for schools and pupils is very small, but the boost to teaching productivity is noticeable. Their system is currently installed in 35 000 classrooms across the country and they believe they can add at least an equivalent amount every year for the next five years to get them to 300 000 classrooms. With the hardware provision effectively outsourced, the marginal cost associated with adding new classrooms is very low. Consequently earnings from this flagship product should increase by 25% to 30% per year if they only do half of what they project.

Educomp also operate several 'brick and mortar' private schools – 62 in total with a further 20 under construction. Many of these schools are in joint ventures with reputable international education providers. The completed schools currently have 25% of the students they could theoretically hold due to government regulation that forces them to stagger enrolment programmes over four years. If they did not build another single school, and with the construction costs paid on the schools they already have opened; earnings in this division would still grow by a cumulative 500% as the schools fill up over the period to 2014. Educomp is irrationally cheap at a single-digit earnings multiple, especially when one considers that most of the Indian market is quite expensive compared to other emerging markets.

After visiting Brazil we added food producer M Dias Branco to the fund. This producer of pasta, cookies and crackers has, on average, twice the market share of its main competitors and a superior distribution system. The market is still fairly fragmented and the bigger producers are likely to consolidate the market over time, leading to higher margins and a multiplied effect on profits. In an environment where most emerging market food producers trade on at least 20 times earnings, M Dias is incredibly cheap at close to 10 times earnings. With a solid franchise and continued investment in brands and distribution we expect earnings to grow strongly over the next four to five years.

We continue to look for opportunities and regularly visit countries in search of ideas. Members of the team have already undertaken five two-week trips to destinations in Asia and the Americas this year and several additional trips are planned for the remainder of 2011. In a constantly changing environment, this process is essential to understand the market and assess management's focus and ability to deliver returns to shareholders.

Coronation Global Bond

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Oct 09	13.34%	–	–	6.39%
Benchmark		10.54%	–	–	4.09%

Annualised, quoted in USD

The Citigroup World Government Bond Index returned 3.32% (in US dollars) during the quarter, while the fund returned 4.1%.

Global bond markets proved to be anything but dull. The yield on the US 10-year Treasury reached its peak of 3.6% in mid-April, then rallied throughout the quarter reaching a low of 2.8% as the US hit a soft data patch. Investors then had to deal with an aggressive sell-off in yields that coincided with the end of the second round of quantitative easing and the US hitting its debt ceiling. Mexico proved to be the best performing market over the quarter, up nearly 5% in local currency terms with the Anglo-Saxon economies delivering returns closer to 2.5%. Peripheral Europe once again delivered the worst returns, with Portugal being the worst performer in the index (down 10.5%) and Greece (no longer in the index) down 15%.

The backdrop to the market movements, however, has been down to two factors, namely the widespread disappointment in data emerging from the US in particular as well as the events in Greece that have transfixed the markets in recent months.

The softer data patch saw commodities unwind some of their recent appreciation and a basket of commodities fell by around 7% during the quarter. Oil, previously buoyed up by North African concerns, fell from $115 to $95 aided by the release of 60 million barrels of reserves by the International Energy Agency. Wheat, which traded as high as $970 in February, fell to $615 as US farmers planted the second most acreage since 1944. Globally breakeven rates of inflation narrowed as inflation concerns eased with the US 10-year breakeven rate trading as high as 2.45% and as low as 1.8% during the quarter.

The approach of central banks continues to be very different. In the US, the Federal Open Market Committee has signalled that the period of ultra low rates is likely to last until at least 2012. US Treasury Bills with maturities of shorter than three months recently traded at a zero yield with rates to the end of 2012 as low as 0.07%. Meanwhile within the eurozone policy makers have been more hawkish raising the ECB repo rate twice, by 0.25% to 1.5%. This ended the period of unchanged rates that stretched back to August 2009. In the UK the Bank of England has turned a blind eye to CPI which has only briefly been below the upper band of its target range during the last few years and has chosen to focus more on real wages and money supply. In fact, some members of the Monetary Policy Committee is so concerned about growth (incidentally not part of their mandate) that another round of quantitative easing has been discussed.

In the foreign exchange markets, the Swiss franc was the best performing currency, making new historic highs against both the US dollar and euro as it benefited from safe haven flows and a relatively robust economy. Elsewhere the emerging market and commodity-based currencies continued to do relatively well despite weaker commodities and a rise in global risk aversion. Among the majors, the yen performed best reversing some of the weakness that occurred after G7 intervention in March 2011. Despite government bond yields reflecting concerns in peripheral Europe the euro/dollar continued to be driven mainly by the relative interest rate differentials between the US and core Europe.

Corporate bonds performed very strongly in the early part of the year benefiting from lower government yields and tighter credit spreads, with higher yielding credit performing exceptionally well. We began to see a more mixed picture emerge as new issuance caused a certain amount of market indigestion and heightened risk concerns surrounding Greece spilled over into the market.

The fund remains underweight duration, largely through underexposure to Japan where the fund holds inflation-linked bonds over conventional fixed-rate bonds. During the quarter the fund sold out of several credits (Naspers, Deutsche Bank and Supervalu) and took a new holding in Investec Bank. The fund is underweight in yen and euros, broadly neutral in the US dollar and overweight in currencies in Scandinavia, Australia, Canada and the UK.

Coronation Africa Frontiers

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Oct 08	14.37%	–	–	19.45%
Benchmark		5.31%	–	–	5.65%

Annualised, quoted in USD

The fund had a decent quarter, rising 3.3%. However, year to date the fund lost 1.8%. Given what has been happening in markets across Africa (and the world), we regard this as a decent performance and worth exploring in a more detail.

One quarter of the fund is invested in Egypt, a market that has fallen by 27% since the start of the year. Another quarter of the fund is invested in Nigeria, where the market is flat over the same period. We also have 6% of the fund invested in Kenya, which is down 19%. On a weighted basis, these markets representing over half the fund have fallen 14% year to date. Of the countries in which we have invested more than 5% of the fund, only Zimbabwe (12% of fund) has had a decent year, up just over 11%.

Given what has happened in the markets we are exposed to, how did the fund manage to lose just less than 3%? The answer is that we don't buy markets; we buy positions in select companies. Subsequently the companies in which we are invested performed better than their respective markets. We also tend to take large positions in businesses where we have a high degree of confidence and valuations are attractive.

For example, 12% of the portfolio is invested in brewers in Nigeria which are up 21% year to date. Another 6% of the fund is invested in two Nigerian banks: the only two banks in the market to have generated positive returns this year. Our performance in Egypt has been less convincing. But here too the shares we hold have, in aggregate, performed substantially better than the market. We are likely to do some re-allocation in Egypt, focusing our holdings in those companies where we have the highest conviction. We continue to believe that valuations in Egypt are attractive and that significant returns are on offer for the patient investor. But, political and economic progress will not follow a smooth path and we want to ensure that our holdings are concentrated in those companies most likely to emerge as the biggest winners.

Pliny the Elder is said to have commented: 'Ex Africa semper aliquid novi' (out of Africa, always something new), and investing where we do is certainly never dull. Demonstrations in Egypt continue as the country gears up to write a new constitution and elect a new leader and parliament. Elections may have been deferred in Zimbabwe but the coalition government only limps along as President Robert Mugabe remains as stubborn as ever. Inflation in Kenya is back with a vengeance and famine is once again spreading its deadly fingers across north-east Africa. In Nigeria, the new government is not yet fully formed (though some positive appointments have been made) while the banking sector that dominates the market is still taking a battering. On the positive side, Ghana is seeing the benefits of first oil, some interesting listings are coming out of Rwanda and Zambia continues to benefit from high copper prices.

We continue to find interesting opportunities in which to invest. And we continue to believe that our valuation-driven approach to investing will reward our investors over the longer term.

Indonesia

A worthy BRIC contender

by **SUHAIL SULEMAN**

***SUHAIL SULEMAN** joined Coronation's Emerging Markets team in 2007, initially covering the consumer and industrial industries. He currently co-manages the range of Global Emerging Markets funds. Suhail has nine years' investment experience.*

The BRIC acronym can be misleading since it includes four very different types of countries. Brazil is now a middle income country and steadily becoming wealthier due to prudent economic policies introduced in the mid-1990s that have resulted in sustained economic growth and improved financial stability. In contrast, Russia's population is in danger of ageing and shrinking before becoming rich, while its economy is unable to free itself from the impact of global oil and gas prices. India remains the poorest member of this group on a per capita basis but its young population, improving productivity, heavy infrastructure investment and positioning as a large English speaking market for outsourcing of services, should see the country grow strongly for many years to come. China continues to astound economists as it has maintained near double-digit growth for (now) over 30 years, transforming the country from a poor rural backwater into a modern, majority urban society with the second largest economy in the world.

South Africa has been lobbying for some time for inclusion in this exclusive BRIC club. However the BRIC group is far from uniform, except that they all have large populations and a decade ago were expected to grow very fast for many years and eventually challenge developed nations at the top of the world's economic tables. If the application process were open to all countries and the main criteria included a large population and high growth rate then the obvious contender for inclusion would not be South Africa but Indonesia.

Indonesia and South Africa share a common history of Dutch colonisation, but are very different societies. The country is made up of over 17 000 islands and has a population of 240 million people, making it the fourth most populous nation after China, India and the US. It is commonly cited as the largest Muslim nation and (some recent instances aside) a fairly tolerant multi-cultural and multi-racial society. The 50 years after independence from the Netherlands were varied with some periods of decent economic growth, but also challenging political eras – firstly under Sukarno and later Suharto who both ruled with an iron first. Over the years the economy became dominated by a few powerful families with close ties to the ruling regime and it was at times impossible to bypass these families when doing business in the country.

The Asian Crisis of 1997 – 1998 changed things forever. No other country affected by the crisis experienced trauma to the extent that Indonesia did. The currency depreciated from 2 600 rupiahs per dollar to a low of 14 000 rupiahs per dollar (over 500%), the economy shrank by 13% and the banking system collapsed requiring virtually a complete central government takeover of the financial sector. All this turned out to be somewhat of a blessing in disguise as the ensuing public outcry against the country's leadership led to the fall of the ruling regime and the advent of competitive multiparty politics for the first time. Many family conglomerates were wiped out by the collapsing banking system and their stranglehold over the economy was finally broken. In the space of a few months, the country was given a chance to reshape its destiny. Consequently, Indonesia has emerged as one of the most attractive investment markets at current valuations.

Since the turn of the century the country's economy grew at an average rate of 5.4% per annum, raising living standards substantially. GDP per person in 1998 was $478, today it is over $3 000 helped in part by a recovery in the currency. Inflation has mostly been in single digits throughout this period, while the banking system has been nurtured back to health and mostly freed of government ownership. It is difficult to believe that a country that just over a decade ago teetered on the edge of bankruptcy, today boasts a debt to GDP ratio of 25%, a fraction in comparison to most of the first world debt to GDP ratios, and can borrow in international capital markets in dollars for 10 years at 4.5% interest rates.

For foreign investors there are several industries that are attractive in Indonesia, the most obvious of which is mining since the country is blessed with abundant natural and mineral resources. Indonesia produces more coal than South Africa, with higher energy content, lower extraction costs and easy shipping routes to major consumers like China. It is a top 10 producer of timber and forestry products, while it is the largest producer of palm oil, a key ingredient in cooking and detergents. Indonesia has dozens of listed companies offering investors exposure to all these sectors.

The consumer sectors offer arguably even greater potential. On almost every measure Indonesia's consumer sector is just starting to, for lack of a better word, consume. Per capita consumption of most fast moving consumer goods (FMCGs) that we would consider everyday items is lower than most other countries at a similar level of development, and a fraction of consumption in the developed world. It is no surprise that the world's biggest multinationals view Indonesia so favourably that they are rapidly expanding operations there. Companies like Unilever, operating in the country since the 1930s, believe that they can sustain the 15% annual revenue growth they have achieved over the last decade for at least another decade.

Historical precedent elsewhere in the region suggests this expectation is not misplaced – as people become wealthier and their base needs are satisfied they start to trade up and consume greater quantities of FMCGs. Once a certain threshold is reached they start to purchase durable household products like washing machines and vacuum cleaners to make their lives easier. Consumption of big ticket items in Indonesia is abnormally low for the same reason that vehicle finance and mortgage lending are relatively non-existent – Indonesia's banking system has only just started lending.

Prior to the Asian Crisis, most banks simply collected deposits from the public and provided cheap finance to the family conglomerates that controlled them. Any independent company dealing with a conglomerate had to use the designated bank for all transactions and this helped to keep money 'in the family'. The collapse of the banks and workout of bad loans means that for the first time in the country's history, banks now actually collect deposits from the public and lend to people and small businesses. Lending to individuals and small to medium enterprises for consumption, vehicles and property can grow at double digits for many years and Indonesia will still rank as one of the least banked countries in Asia.

In the process, millions of new homes and commercial properties will be built and tens of millions of families will purchase motorbikes, cars, white goods and televisions for the first time. This is a huge market opportunity for many manufacturers in the region who, till now, have relied on an industrialising China as their main target market. Telecommunication infrastructure is also expected to develop rapidly – most of this disperse country is covered by mobile operators despite the geographical challenges they face, giving people access to voice services for the first time. Data consumption has barely started and internet usage has historically been shown to boost productivity and hence GDP growth even further.

Indonesia faces many challenges, not least of which is endemic corruption that has barely been tackled despite the obvious effect it has on the public sector. Fuel subsidies consume 10% of the public budget and attempts to reduce these have often been met by rioting on the streets. Yet overall the steps taken since 1998 and the continued emphasis on investment in infrastructure suggest the country can maintain the 6% growth rate required to double the size of the economy every 12 years. At these sorts of growth rates, within 20 years the Indonesian economy could overtake Russia's in size, so perhaps South Africa's claim for inclusion in the BRIC grouping has less merit than we care to admit.

Coronation's Global Emerging Markets Funds hold two Indonesian stocks in the respective portfolios. Global Mediacom is the largest free-to-air television broadcaster in the country and also happens to have a very strong pay-TV business. This company should benefit tremendously from increased advertising spend by multinationals looking to build their brands in such a large and attractive consumer market that cannot be effectively reached by print media due to that industry's fragmented nature and the huge distribution costs in such a disperse nation. We like the broadcasting model since it is very cash generative once mature, and tends to reward companies with the largest share of the market disproportionately well due to the advertising rates that they command. Our other holding is Mayora Indah, a confectionary company, with many top tier brands in biscuits, candy, chocolates and instant coffees. The company continues to grow sales and earnings strongly at 20% p.a., despite strong competition from all the established multinationals. It can be bought at 16 to 17 times earnings compared to 26 times earnings for the more glamorous Unilever Indonesia.

On-the-ground experience of visiting a country adds tremendous value to understanding how its businesses operate and the assessment of the underlying management culture. With this in mind our team has visited Indonesia twice since our funds were launched three years ago and we are due to visit again before the end of the year. Through this ongoing process we hope to find more opportunities to deliver sustainable market-beating returns for our investors.

Guest contributor

Adelphi Capital was founded in 1997 by Roderick Jack and Marcel Jongen, who have co-managed European equities for 19 years. Prior to founding Adelphi, Rod and Marcel started the European equity long-only business for Goldman Sachs Asset Management in 1992. With approximately $1.4 billion under management, Adelphi manages two fundamentally focused, European equity long-short strategies: Adelphi Europe and Adelphi Emerging Europe. The flagship hedge fund strategy, Adelphi Europe, was launched in 1997 and a long-only version of the strategy, Adelphi European Select Equity, was introduced in 2007. Both Adelphi Europe and Adelphi European Select Equity are co-managed by Rod and Marcel whose fundamental, bottom-up research process focuses on identifying the most attractive opportunities within western European equities across sectors and market caps. The research process is comprised of rigorous, company-specific analysis to create a portfolio that is diversified across countries and sectors.

Adelphi European Select Equity

The portfolio has particularly benefited this year from having very little direct exposure to energy, commodity or bank shares. We structurally avoid companies in the first two sectors as we feel they are too driven by the macro environment and have less direct control over their own fortunes compared to other sectors. Instead, we prefer to invest in companies that offer products or services and business strategies that allow them to outgrow their peers and create value in a range of economic environments. As for the banking sector, we currently see far too much political, regulatory, financial and balance sheet uncertainty to be able to make confident forecasts about future risks and returns. Furthermore, low credit growth across Europe, even in sounder economies, means that underlying earnings growth is generally low. Consequently, for now, we choose to ignore this sector.

Our absence from what we consider to be some of the most uncertain parts of the market does not mean that our long book is immune to the business environment. That said, most of the positions in the long book currently are businesses that we think have a sufficient weight of company specific momentum – whether from market share gain, business turnaround, to capital expansion, etc. Whereas in 2009 we found that many of the most glaring valuation anomalies were in companies that had been affected severely by the recession or by their weak financial structure – and which as a result were being avoided by a very risk-averse investor base. Today we find many of these companies fully valued, and with analysts forecasting that they will achieve higher returns than ever before. Higher returns might well happen, but the case becomes overly dependent on the performance of the global economy and we would rather not spend our time poring over Chinese PMI data or US payrolls to find out how our companies might perform in the near future.

The relatively large weight to industrials shown in our sector breakdown is factually correct according to index classifications, but is a little misleading. For example, it includes credit bureaus and consumer marketing databases (Experian), inspection and testing laboratories (Intertek) and airline catering (gategroup). Our two true industrial manufacturing positions are Schneider Electric, a superbly managed electrical equipment manufacturer which we think will outgrow the economy due to trends towards energy efficiency, building automation, smart electrical grids and data centres. The other is Schindler, a leading global supplier of elevators whose profits are driven substantially by recurring service and maintenance revenues.

The raft of global economic data over the past month suggests that a moderation in the pace of growth is taking place, which has naturally dampened market sentiment somewhat and caused weakness in the stocks and commodities that would be impacted most directly by a slowdown. We should be watchful because some degree of economic growth and price inflation is necessary to sustain the healing process of government and bank finances around the world and a lurch back into recession could have dire consequences. Furthermore, many companies are reliant on improved pricing power and additional pressure on corporate and consumer income might make this difficult to achieve. However, we do not think that the evidence so far points to such a dramatic change in circumstances that would require us to start altering our fundamental assumptions about portfolio holdings and hence the underlying positioning of the fund. Nevertheless, we will remain watchful for reasons to change our current belief that we own some excellent companies with good prospects at reasonable prices.

In the first quarter of this year, we initiated a long position in Spanish clothing retail company Inditex and have recently added to the position as our conviction has further increased. Inditex is one of the world's largest fashion retail companies whose eight brands (Zara, Pull and Bear, Massimo Dutti, Bershka, Stradivarius, Oysho, Zara Home and Uterqüe) are sold in their own respective stores. We have followed Inditex since its initial public offering (IPO) in 2001 and have owned it in the past.

The weak share price performance within the industry interested us, and we sought to better understand the headwinds in the retail supply chain for a handful of clothing manufacturers (e.g. cotton price, wage inflation in China, currency and capacity constraints). At the end of that exercise, we concluded that Inditex remains one of the best run retail companies in the world, and we believe the company should overcome the gross margin pressures which contributed to a negative consensus view on the industry.

We believe Inditex has a distinct advantage by having some of the shortest lead times for garment production in the industry. The company does this by sourcing less of its production in China, unlike most of its competitors, in favour of closer proximity relationships (e.g. Europe, North Africa). A recent site visit to the Zara distribution centre in La Coruna, Spain deepened our appreciation of the sophistication of the company's design process which incorporates the constant feedback and sales metrics from store managers to adjust the design of individual pieces in its collection thereby limiting the risk of fashion misses or markdowns. Both the high fashion credibility and slightly higher price point of Inditex's clothing affords the brand a larger latitude for altering collections and prices compared to some of its peers with more discounted, static product offerings.

The company is global in its scope and of its approximately 5 000 stores in more or less 80 countries, Spain represents less than 30% of sales. We believe Inditex still has room for substantial growth in many new markets. The key attraction to us as investors is the high return on equity (over 40%), growth opportunities through new store openings, and significant free cash flow yield. Specific diligence on shopping centres in China highlighted to us the potential growth Inditex can capture in that market with multiple formats in the next few years. Furthermore, we expect additional like-for-like growth because of the recent roll out of online stores in a few additional countries. We think the online concept might allow Inditex to grow disproportionally in the US when it launches later this year.

Perhaps most importantly, the aggressive expansion efforts are part of the company's DNA. The company has a considerable net cash position on its balance sheet and generates significant free cash flow yield. Rarely do we encounter growth opportunities that are so cash generative.

PORTFOLIOS[Δ]	FEES°	LAUNCH DATE	1 YEAR	3 YEARS	5 YEARS	CUM SINCE LAUNCH†	ANN SINCE LAUNCH†
GLOBAL BALANCED							
Houseview	G	01-Oct-93	19.71%	12.43%	13.59%	1 588.10%	17.26%
Peer Median*			17.86%	8.25%	10.26%	1 208.89%	15.59%
Managed	G	01-Apr-96	22.00%	14.16%	14.75%	1 087.31%	17.62%
Peer Median*			17.86%	8.25%	10.26%	644.99%	14.07%
DOMESTIC BALANCED							
Domestic Houseview	G	01-Jan-98	22.23%	14.14%	15.31%	808.28%	17.75%
Peer Median*			20.43%	11.37%	12.87%	668.54%	16.31%
SPECIALIST EQUITY							
Core Equity	G	01-Mar-04	27.92%	13.72%	16.73%	364.59%	23.30%
FTSE/JSE Shareholder Weighted Index			24.39%	7.55%	12.31%	278.89%	19.92%
Houseview Equity	G	01-May-00	27.09%	13.84%	16.17%	666.26%	20.00%
FTSE/JSE Shareholder Weighted Index[1]			24.39%	7.55%	11.93%	433.83%	16.18%
Aggressive Equity	G	01-Jan-04	30.12%	17.11%	17.32%	386.48%	23.48%
FTSE/JSE Shareholder Weighted Index			24.39%	7.55%	12.39%	294.41%	20.08%
SPECIALIST FIXED INTEREST							
Institutional Cash	G	01-Sep-06	7.20%	9.23%	–	54.47%	9.41%
Short Term Fixed Interest 3-month Index			5.86%	7.99%	–	49.20%	8.63%
Active Bond	G	01-Jul-00	12.09%	14.33%	9.79%	278.12%	12.85%
BEASSA All Bond Index			11.32%	13.42%	8.86%	251.53%	12.11%
Strategic Bond	G	01-Jan-08	12.54%	14.98%	–	43.45%	10.86%
BEASSA All Bond Index			11.32%	13.42%	–	36.16%	9.22%
INFLATION-LINKED BENCHMARK							
Global Absolute	G	01-Aug-99	15.43%	14.76%	13.76%	627.37%	18.12%
CPI + 6% p.a.			11.02%	11.48%	12.85%	305.18%	12.46%
Domestic Absolute	G	01-Apr-02	18.10%	17.38%	15.48%	422.67%	19.58%
CPI + 5% p.a.			10.02%	10.48%	11.85%	164.65%	11.09%
Inflation Plus	G	01-Oct-09	13.39%	–	–	24.68%	13.44%
CPI + 3.5% p.a.			8.52%	–	–	13.93%	7.74%
Medical Aid Absolute	G	01-Apr-04	15.65%	14.95%	13.65%	205.33%	16.64%
CPI + 3% p.a.			8.02%	8.48%	9.85%	86.18%	8.95%
HEDGE FUNDS							
Presidio	N	01-Oct-05	23.18%	19.97%	17.27%	144.49%	16.82%
Cash + 7% p.a.			12.65%	14.80%	15.57%	127.47%	15.37%
Multi-Strategy Arbitrage	N	01-Jul-03	11.94%	15.30%	14.21%	200.52%	14.75%
Cash + 5% p.a.			10.65%	12.80%	13.57%	170.25%	13.23%
Granite Fixed Income	N	01-Oct-02	9.92%	11.63%	11.03%	160.28%	11.55%
Cash + 3% p.a.			8.65%	10.80%	11.57%	161.48%	11.61%
OFFSHORE FUNDS[2]							
Global Equity FoF (US$)	N	01-Jul-00	28.05%	5.52%	5.17%	51.73%	3.86%
MSCI World Index (US$)			31.19%	1.05%	2.85%	19.86%	1.66%
Global Equity Alternative Strategy FoF (US$)[3]	N	01-Aug-96	14.44%	3.57%	4.18%	266.19%	9.09%
50% MSCI World Index + 50% USD Cash (US$)			18.49%	0.58%	3.52%	103.75%	4.89%
Global Managed (US$)	G	01-Mar-10	25.09%	–	–	16.53%	12.15%
60% MSCI World Index + 40% Citigroup World Government Bond Index (US$)			22.74%	–	–	17.05%	12.54%
Global Capital Plus (US$)[4]	G	01-Sep-09	18.63%	–	–	21.35%	11.13%
50% 3-month USD Libor + 50% 3-month Euro Libor (US$) + 1.5%			11.40%	–	–	4.88%	2.63%
Global Bond (US$)	G	01-Oct-09	13.34%	–	–	11.46%	6.39%
Citigroup World Government Bond Index (US$)			10.54%	–	–	7.27%	4.09%
Global Emerging Markets (US$)	G	14-Jul-08	39.44%	–	–	49.52%	14.55%
MSCI Emerging Markets Index (US$)			28.17%	–	–	18.86%	6.01%
Africa (US$)	G	01-Aug-08	23.13%	–	–	57.07%	16.74%
3-month USD Libor + 4%			4.31%	–	–	14.68%	4.81%
Africa Frontiers (US$)	G	01-Oct-08	14.37%	–	–	63.01%	19.45%
3-month USD Libor + 5%			5.31%	–	–	16.31%	5.65%

Δ Figures are quoted from the Independent Retirement Fund Survey as at 30 June 2011.
1. Benchmark for Houseview Equity changed from FTSE/JSE Capped All Share to the Shareholder Weighted All Share Index on 1 July 2007.
2. Figures quoted in US$ as at 30 June 2011.
3. This fund is available to institutional investors only.
4. Formerly known as Global Latitude.

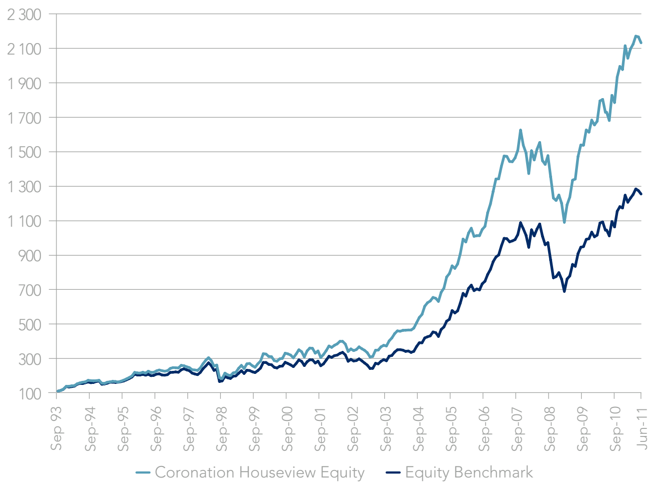
° G = Gross, N = Nett
† CUM SINCE LAUNCH = Cumulative returns since launch, ANN SINCE LAUNCH = Annualised returns since launch. Figures of one year and less indicate percentage change.

** 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.*

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 6 months to June 2011	12.27%	8.79%	3.48%
ANNUALISED TO 30 JUNE 2011			
1 year	27.1%	24.4%	2.7%
3 years	13.8%	7.5%	6.3%
5 years	16.2%	12.4%	3.8%
10 years	19.8%	16.0%	3.8%
Since inception in October 1993 annualised	18.8%	15.3%	3.5%
Average outperformance per 5-year return			3.52%
Number of 5-year periods outperformed			14
Number of 5-year periods underperformed			–

CUMULATIVE PERFORMANCE



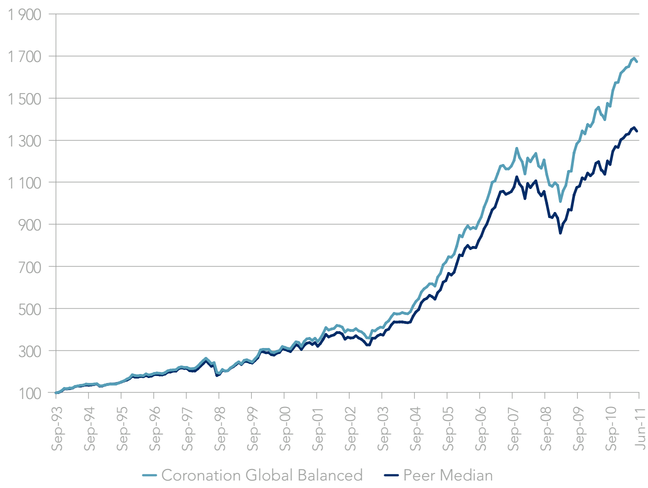
ANNUALISED RETURNS SINCE INCEPTION

An investment of R100 000 in Coronation Houseview Equity on 1 October 1993 would have grown to **R2 128 815** by 30 June 2011. By comparison, the returns generated by the Equity Benchmark over the same period would have grown a similar investment to **R1 249 191**.

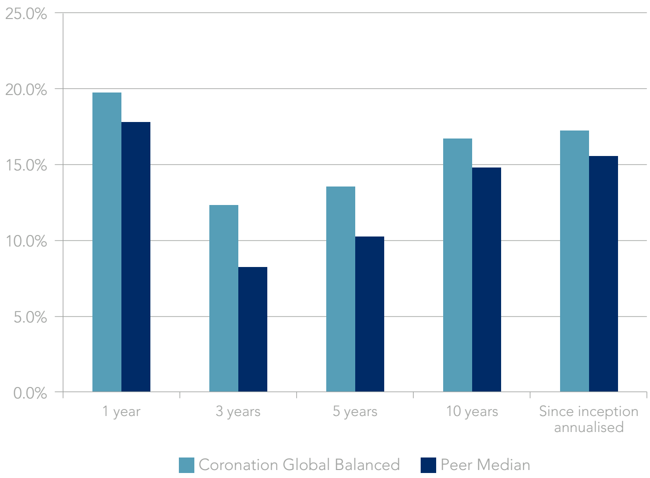
CORONATION GLOBAL BALANCED RETURNS VS PEER MEDIAN**

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%	1.22%
2007	24.93%	24.82%	0.10%
2008	18.96%	17.52%	1.44%
2009	18.28%	15.19%	3.09%
2010	15.23%	12.02%	3.21%
4 years 6 months to June 2011	11.20%	7.51%	3.69%
ANNUALISED TO 30 JUNE 2011			
1 year	19.7%	17.9%	1.8%
3 years	12.4%	8.3%	4.2%
5 years	13.6%	10.3%	3.3%
10 years	16.7%	14.8%	1.8%
Since inception in October 1993 annualised	17.3%	15.6%	1.7%
Average outperformance per 5-year return			1.47%
Number of 5-year periods outperformed			13
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 688 097** by 30 June 2011. By comparison, the median return of peers over the same period would have grown a similar investment to **R1 355 024**.

*** 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.*