CORONATION
STRATEGIC BOND STRATEGY
INSTITUTIONAL STRATEGY FACT SHEET AS AT 31 MARCH 2019

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LONG TERM OBJECTIVE

The Coronation Strategic Bond Strategy is an actively managed fixed interest solution that allocates across all the different fixed income instruments. The Strategy has a flexible mandate with no duration or term restrictions. The Strategy invests in the traditional fixed interest assets, but can also invest in listed property, preference shares and inflation-linked bonds, which are typically excluded in most specialist mandates. This flexibility allows the Strategy to maximise every opportunity in the domestic fixed interest space and produce superior returns for clients. The Strategy aims to consistently outperform the JSE ASSA All Bond Index over the medium to long term.

INVESTMENT APPROACH

Coronation is a long-term, valuation-driven investment house. Our aim is to identify mispriced assets trading at discounts to their fair value through extensive proprietary research. The fixed income portfolios are positioned on a long term strategic market view, but this is balanced by taking advantage of shorter-term tactical opportunities when the market lags or runs ahead of that strategic view. As active managers, we consider investment decisions across the full spectrum of potential return enhancers. These include duration and yield curve positions, inflation-linked assets as well as yield enhancement through credit enhanced assets. We aim to maximise returns by actively combining both a top-down and a bottom-up approach to portfolio construction.

STRATEGY RETURNS GROSS OF FEES

Period	Strategy	Benchmark	Active Return
Since Inception (cumulative)	190.7%	154.6%	36.1%
Since Inception p.a.	10.0%	8.7%	1.3%
Latest 10 years p.a.	9.9%	8.7%	1.2%
Latest 5 years p.a.	9.0%	8.3%	0.7%
Latest 3 years p.a.	10.5%	10.1%	0.4%
Latest 1 year	3.0%	3.5%	(0.5)%
Year to date	3.8%	3.8%	0.0%
Month	1.0%	1.3%	(0.3)%

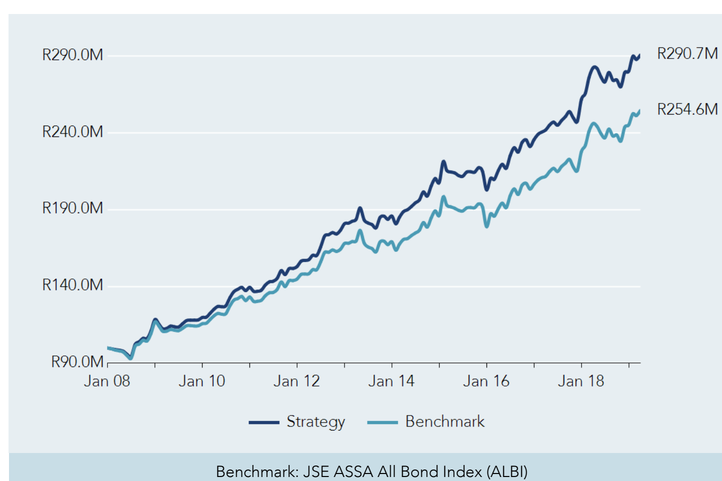
ASSET ALLOCATION

Asset Type	% Strategy
Fixed Rate Government Bonds	60.7%
Fixed Rate Corporate Bonds	14.7%
Cash	9.2%
Property	6.5%
Corporate ILBs	3.0%
Floating Rate Corporate Bonds	2.2%
Fixed Rate Other	1.5%
Government ILBs	1.1%
Floating Rate NCDs	0.6%
Fixed Rate NCDs	0.5%

GENERAL INFORMATION

Inception Date	01 January 2008
Strategy Size	R5.79 billion
Strategy Status	Open
Mandate Benchmark	JSE ASSA All Bond Index (ALBI)
Dealing Frequency	Daily
Base Currency	ZAR

GROWTH OF R100M INVESTMENT



Benchmark: JSE ASSA All Bond Index (ALBI)

EFFECTIVE MATURITY PROFILE*

Term	% Strategy	% Benchmark
0 to 1 year	1.4%	17.1%
1 to 3 years	2.4%	5.6%
3 to 7 years	9.1%	6.0%
7 to 12 years	11.0%	32.5%
Over 12 years	69.6%	49.0%

STRATEGY STATISTICS*

	Strategy	Benchmark
Modified Duration (incl. inflation-linked bonds)	7.0	7.3
Modified Duration (excl. inflation-linked bonds)	6.8	7.3

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PORTFOLIO MANAGERS

Nishan Maharaj - BSc (Hons), MBA

Nishan is head of Fixed Interest and responsible for the investment unit's process and performance across all strategies. He also manages the majority of fixed interest assets. Nishan has 16 years' investment experience.

Adrian van Pallander - BScEng, HTSdip, CFA, FRM

Adrian joined Coronation in 2002 and is a portfolio manager within Coronation's Fixed Interest investment unit. He is responsible for managing a portion of the fixed interest assets across all strategies as well as analysis, asset allocation modelling and portfolio construction monitoring. He has 17 years' investment experience.

Seamus Vasey - BCom (Hons), MSc

Seamus co-manages the Coronation Global Bond Strategy and has 15 years' experience in financial markets. Seamus joined Coronation's Fixed Interest investment unit in August 2015 and is a graduate of the London School of Economics.

DISCLAIMER

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* For SA Fixed Income investments only. Excludes international investments, equities, property and preference shares.

REVIEW FOR THE QUARTER

The All Bond Index (ALBI) returned 3.8% for the first quarter of 2019 (Q1-19), bringing its return over the last 12 months to 3.5%. Inflation-linked bonds (ILBs) continued to lag nominal bond performance, producing 0.6% over Q1-19 and -3.1% over the last 12 months. In US dollars, local bonds returned 2.8% in Q1-19, in line with the 2.9% returned by other emerging markets (as measured by the JPMorgan GBI-EM Global Diversified Index), however it remains quite a laggard over 12 months (-15.6% versus -7.5%). The 10-year benchmark bond traded in quite a narrow range over Q1-19 (9.47% to 9.08%).

Global data remained mixed in March, with some tentative signs of a stabilisation in growth momentum but ongoing weakness in global trade and manufacturing. The month's news was dominated by the UK's messy Brexit negotiations, following a European Union extension in late March to a May 22nd deadline. The issue remains unresolved. Elsewhere, very dovish outlook statements from both the US Federal Reserve (Fed) and European Central Bank continue to be supportive of risk assets.

In the US, GDP for the fourth quarter of 2018 was revised lower to 2.2% from 2.6% quarter-on-quarter (q/q) seasonally adjusted and annualised (saa), on weaker consumer spending and business investment. Data continue to be affected by the US government shutdown, both in terms of impact and potentially also on the quality of the data. Nonetheless, available high-frequency data have been mixed: February retail sales were weaker than expected, however jobless claims continue to fall, and the unemployment rate fell back to 3.8% from 4.0% the month before. Housing data was also stronger, with new home sales growth up strongly in February. ISM March manufacturing data also surprised to the upside, rebounding to 55.3 from 54.2 in February.

Consumer inflation continues to moderate. Headline inflation was 1.5% year-on-year (y/y) in February from 1.6% y/y in January, core inflation was 2.1% y/y from 2.2%, while core PCE (personal consumption expenditure) inflation was lower at 1.8% y/y in January from 1.9% y/y in December. The Fed retained its dovish position in March and no longer expects to raise the policy rate in 2019.

At the end of February, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 8.27% (three-year) and 8.74% (five-year); unchanged over the month. The spreads of floating-rate NCDs have dulled in appeal over the last few quarters on the back of a compression in credit spreads. This is due to the reduced need for funding from banks in South Africa, given the low-growth environment. Fixed-rate NCDs continue to hold appeal due to the inherent protection offered by their yields and relative to our expectations for a stable repo rate. However, credit spreads remain in expensive territory (less than 100 basis points [bps] in the three-year area and 110 bps in the five-year area). The strategy continues to hold decent exposure to these instruments (less floating than fixed), but we will remain cautious and selective when increasing exposure. NCDs have the added benefit of being liquid, thus aligning the liquidity of the strategy with the needs of its investors.

Globally, there has been a complete U-turn by central banks on monetary policy normalisation leading to an inversion of the US yield curve, which has stoked concerns of an imminent US recession. Furthermore, uncertainty remains around the outcome of US/China trade negotiations, and total paralysis surrounding the Brexit process.

Emotions have been running high in South Africa over Q1-19. The Zondo commission continues to reveal the shocking level of corruption that has been prevalent in Government and some of its associated institutions. Years of mismanagement and looting are now resulting in the intensification of load shedding, contributing to an already sombre mood locally. Consumers and corporates have continued to tighten their belts, deepening concerns of continued low growth in South Africa.

The sustainability of South Africa's investment grade rating will remain a key concern. Credible monetary policy has caused inflation and inflation expectations to gravitate towards the midpoint of the band (4.5%), yet it remains adequately accommodative given the subdued growth profile. Growth, or the lack thereof, remains at the core of the country's structural problems. Cyclically, growth should pick up to approximately 1.3% in 2019 and 1.8% in 2020. However, the risk to this outcome is to the downside given the threat of load shedding, the effect it has on business and consumer confidence, and how rising electricity-related costs affect corporate profitability. The burden of low growth and state-owned entity (SOE) support weighs heavily on fiscal policy. Until more concrete structural reforms are put through, it is up to fiscal policy to provide a supportive growth environment and support for SOEs in a manner that does not widen the fiscal deficit or increase South Africa's debt burden. Up to now, this has been well managed, as is evident in the February budget, where despite the R23 billion per year capital injection for Eskom, National Treasury still managed to limit fiscal slippage by cutting expenditure, primarily through a reduction in the wage bill. Unfortunately, given Eskom's precarious financial and operational position, the SOE still poses immense risk to both the fiscus and the economy.

Chronic load shedding and poor local sentiment will continue to weigh on South Africa's growth outcomes. Inflation should remain under control, allowing policy rates to remain stable, at worse. Global monetary policy has once again turned more supportive for risk sentiment, which should help buoy emerging market valuations over the shorter term. At current levels, local government bonds are trading cheap relative to fair value estimates. However, given the longer-term risks posed to the economy from further SOE

deterioration, allocations should be kept at a neutral level. While nominal bonds continue to compare favourably to ILBs, the balance in the front end of the curve has shifted towards ILBs.

Given that we expect inflation to average 5.3% over the next two to three years, only the bonds that have an implied breakeven inflation of close to 5.3% look interesting. This rules out any ILB with a maturity longer than the year 2029. In addition, ILBs carry a materially longer modified duration (capital at risk) than nominal bonds. The I2046 has a modified duration of 20.4 years, while the R2048 (equivalent nominal bond) has a modified duration of 9.8 years – therefore if both the ILB and nominal curve move 100 basis points (bps) higher, one would lose 10.6% more being invested in the I2046 than the R2048. This means that to be invested in longer end ILBs, the implied breakeven needs to be quite a bit lower than the current 5.9% (closer to 5.3%) for it to be an attractive investment. Shorter end ILBs, however, at current levels of a 3% real return and a more realistic break-even inflation do look much more attractive and do warrant positions in a bond portfolio.

The local listed property sector was up 1.3% over Q1-19, bringing its return for the rolling 12-month period to -7%. Listed property has been the largest drag on the strategy, primarily due to generalised equity weakness and idiosyncratic domestic issues relating to the possible closure of Edcon, its impact on the broader property sector, and lower real GDP growth. However, from an income perspective, distribution growth and expectations around future distribution growth remain sound. Despite the underperformance, from a valuation perspective, the sector is still very attractive. The changes in the property sector over the last decade (including the increased ability to hedge borrowings and large offshore exposures) should make listed property more resilient going forward. If one excludes the offshore exposure, the property sector's yield rises to approximately 10.7%, which compares very favourably to the benchmark bond. The strategy maintains holdings in counters that offer strong distribution and income growth, with upside to their net asset value. In the event of a moderation in listed property valuations (which may be triggered by further risk asset or bond market weakness), we will look to increase the strategy's exposure to this sector at more attractive levels.

The preference share index was up 6.3% over Q1-19, bringing its 12-month return to 18.7%. Preference shares offer a steady dividend yield linked to the prime rate and, depending on the risk profile of the issuer, currently yield between 9% and 11% (subject to a 20% dividends tax, depending on the investor entity). The change in capital structure requirements mandated by Basel III will discourage banks from issuing preference shares. This will limit availability. In addition, most of the bank-related preference shares trade at a discount, which enhances their attractiveness for holders from a total return perspective and increases the likelihood of bank buybacks. Despite attractive valuations, this asset class will continue to dissipate, given the lack of new issuance and because it risks being classified as eligible loss-absorbing capital (only senior to equity). The strategy maintains select exposure to certain high-quality corporate preference shares but will not actively look to increase its holdings.

We remain vigilant of risks emanating from the dislocations between stretched valuations and the underlying fundamentals of the local economy. However, we believe that the strategy's current positioning correctly reflects appropriate levels of caution. The strategy's yield remains attractive relative to its duration risk, and we continue to believe that this yield is an adequate proxy for expected strategy performance over the next 12 months.

As is evident, we remain cautious in our management of the strategy. We continue to invest only in assets and instruments that we believe have the correct risk and term premium to limit investor downside and enhance yield.