CORONATION

ACTIVE BOND STRATEGY

INSTITUTIONAL STRATEGY FACT SHEET AS AT 30 SEPTEMBER 2019

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LONG TERM OBJECTIVE

The Coronation Active Bond Strategy represents our best investment view for a specialist bond portfolio. The Strategy is managed in line with Coronation's long-term investment philosophy with asset allocation and bottom-up security selection being actively managed to generate targeted outperformance. 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)	702.9%	586.6%	116.3%
Since Inception p.a.	11.4%	10.5%	0.9%
Latest 15 years p.a.	9.6%	8.7%	0.9%
Latest 10 years p.a.	9.9%	8.8%	1.1%
Latest 5 years p.a.	9.1%	8.3%	0.8%
Latest 3 years p.a.	9.6%	8.9%	0.7%
Latest 1 year	11.2%	11.4%	(0.2)%
Year to date	8.2%	8.4%	(0.2)%
Month	0.7%	0.5%	0.2%

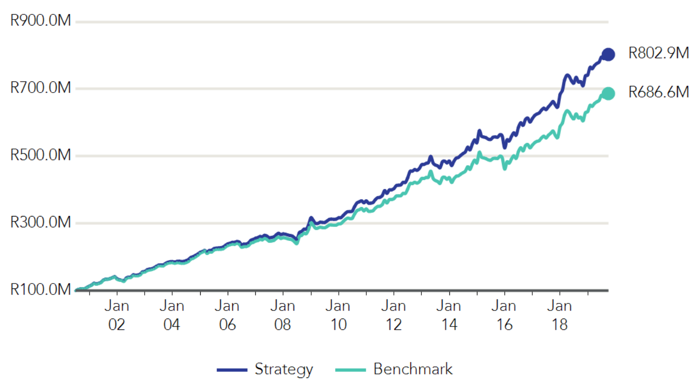
ASSET ALLOCATION

Asset Type	% Strategy
Fixed Rate Government Bonds	75.5%
Fixed Rate Corporate Bonds	6.1%
Fixed Rate NCDs	5.6%
Corporate ILBs	5.3%
Cash	2.9%
Government ILBs	1.5%
Fixed Rate Other	1.4%
Floating Rate NCDs	1.2%
Floating Rate Corporate Bonds	0.5%

GENERAL INFORMATION

Inception Date	01 July 2000
Strategy Size	R7.36 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	7.1%	17.1%
1 to 3 years	1.2%	5.6%
3 to 7 years	9.0%	7.5%
7 to 12 years	14.6%	30.9%
Over 12 years	68.0%	49.0%

STRATEGY STATISTICS

	Strategy	Benchmark
Modified Duration (incl. inflation-linked bonds)	7.3	7.1
Modified Duration (excl. inflation-linked bonds)	7.0	7.1

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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.

Steve Janson - BBusSc

Steve is a portfolio manager and an analyst within the Fixed Interest investment unit with 12 years' investment experience. Steve's current responsibilities include trading as well as co-managing the Coronation Active Bond Strategy.

Seamus Vasey - BCom (Hons), MSc

Seamus is a portfolio manager and analyst within the Fixed Interest investment unit with 15 years' investment experience. He manages assets within Coronation's specialist bond strategies. He also co-manages the Coronation Global Bond and Granite Hedge funds as well as the Global Strategic USD and Bond unit trust funds. Seamus joined Coronation's Fixed Interest investment unit in August 2015 and is a graduate of the London School of Economics.

DISCLAIMER

REVIEW FOR THE QUARTER

Local bond performance was muted in September. The All Bond Total Return Index generated 0.5% for the month and 8.4% year to date. The longer end of the curve (12+ years) delivered the highest return for the month, at 0.7%. Elsewhere, the performance was lacklustre. The 1-3 years returned 0.4%, 3-7 years return was 0.2% and 7-12 years returned 0.2%. Inflation-linked bonds rebounded from August's negative performance and returned 0.4%. Cash returns were unchanged at 0.5%.

An astonishing $15 trillion worth of global government bonds now trade at a negative yield. That's approximately 25% of the market that is trading with a yield to maturity of less than zero. This phenomenon, for now, has been confined to Europe and Japan, and, in extreme cases like Switzerland, Germany and Netherlands, the entire yield curve trades in negative territory (negative yields all the way out to 2050!). Any sane person would ask the question, who in their right mind would be investing in an asset that is guaranteed to lose them money? In a world where the alternatives are overpriced risky assets, where one can suffer permanent loss of capital, or negative cash/deposit rates, suddenly assets at less negative yields and that have consistent buyers in the form of central banks (which makes short-term capital gain possible), look a whole lot better.

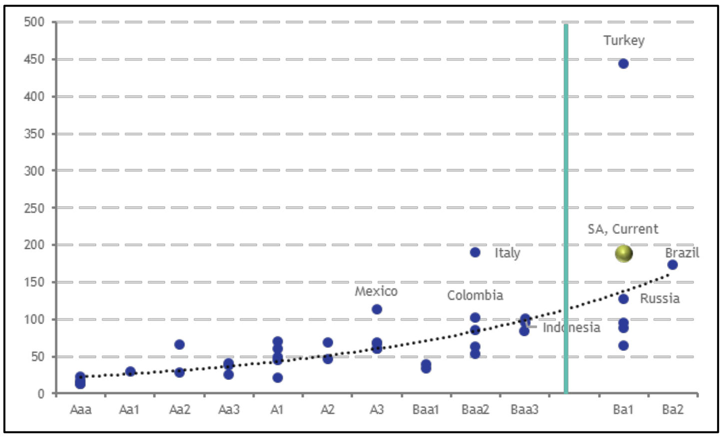
In a world of no yield, one would expect relatively high-yielding assets to be well supported. Since the beginning of the year, emerging market (EM) bonds (as represented by the JPMorgan Emerging Market Bond Index (EMBI) Global Index), returned 12.1% in US dollars. This is despite many EM currencies being down considerably (3%-7%) over the last quarter. SA bonds scraped in with a positive return of 0.7% this last quarter, but over the last twelve months the All Bond Index (ALBI) has delivered an impressive return of 11.4% in rands, which, despite the 6.5% depreciation in the currency over the same period, still produced a positive return of approximately 5% in dollars. Over the last quarter, the SA 10-year (y) bond has traded in the 8.5% - 9% range, with the further rally in global bond yields acting as a strong anchor for local yields.

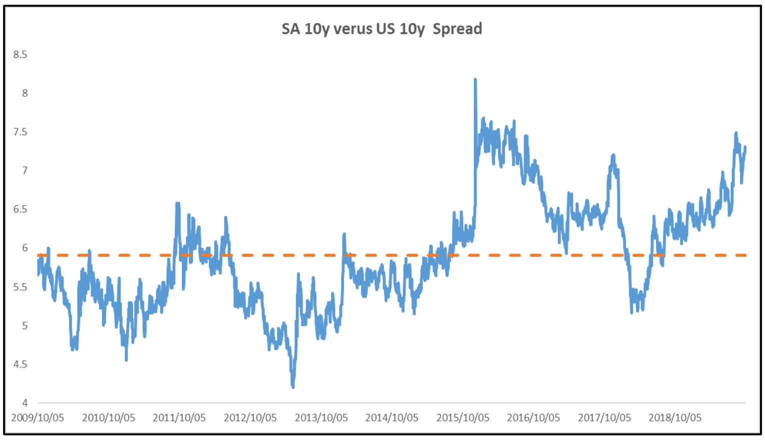
The US 10y bond has rallied from levels of just above 2% to 1.7% over the course of the quarter, for several reasons. The escalation of tension in the US/China trade relationship has dented global confidence, which has led to a material slowdown in the global capex cycle. This has coincided with a slowing in US and global growth. Central banks have been quick to step in and engineer a softer growth landing, with the US reducing interest rates 0.5% this year and the European Central Bank (ECB) moving deposit rates further into negative territory, accompanied with a restart of their bond purchase programme. Current data emerging from Europe points to growth slowing to 1% with inflation of 1.5%, which suggests, at a bare minimum, a continuation of accommodative monetary policy in the EU. US data, more specifically the US labor market, has proved more resilient despite recent cracks starting to appear. The reaction of US Federal Reserve Bank (Fed) has not been as frantic as market pricing of interest rate cuts, and has instead adopted a wait-and-see approach to further rate easing. We are still quite far away from seeing a restart of the US quantitative easing (QE) programme, given the room to move lower on policy rates. The hope is that recent measures implemented by global central banks are enough to mitigate an aggressive growth slowdown in the months to come.

On the local front, we remain in limbo as we await the medium-term budget proposal speech (MTBPS) at the end of October and further details on the turnaround for Eskom. Inflation continues to be well behaved and expectations are for it to average 5% over the next 2-3 years. Growth expectations have been continually revised down, with current expectations for a marginal pick up to 1.5% over the next 2-3 years. Structural reforms have been much talked about, especially in the new National Treasury economic strategy plan released by Finance Minister Tito Mboweni towards the end of the third quarter. Unfortunately, time is running out, and what's needed now is an accelerated implementation of these initiatives in order to bring back confidence and investment into the local economy.

Government finances continue to weigh heavily on the local outlook, with the fiscal deficit expected to breach -6% this year and debt/GDP to push above 60%. The major culprit of this deterioration has been the continued support needed by ailing state-owned entities (SOE's), most specifically Eskom. Without a credible plan to turn around the entity, more money will need to be poured in to allow it to meet its obligations. Herein lies the major risk for the local economy, and, while there has been an acknowledgement of the problems by government, there has been a lack of urgency in putting a credible plan in place to halt Eskom's deterioration, let alone turn the entity around. Moody's is still the only rating agency that rates SA as an investment-grade country and has provided the country with a tremendous amount of leeway over the last 12 months. Their recent statements suggest that they will continue to do so, given the reform intent of government. However, given what is currently known about the trajectory of further deterioration, if there are no substantial efforts to fix the problems the country faces, it is very likely that SA is assigned a negative outlook on our investment grade rating by November 2019 and that SA is downgraded to sub-investment grade territory by 3Q2020.

The deterioration in SA's fundamentals have been well flagged, which has allowed a risk premium to be built into SA government bonds (SAGBs), both in terms of absolute yields and the steepness of the yield curve. SA's credit default spread (represented below) already trades at levels that are consistent with a sub-investment peer group. In addition, 10y SAGBs trades at a spread of 7.3% over US 10y yields, which is well above the long-term average and close to the widest levels it has been in ten years. These measures suggest a significant amount of the bad news is already being priced in by markets.





Source: Bloomberg

Furthermore, SAGBs look quite cheap when compared to the EM universe. In the below table, we show the nominal yields of various EM bond markets and their implied real yields (the return one would get if we strip out the effects of inflation over the next year). SA not only sits well above the EM average but also at the top of the ranking table when it comes to the relative cheapness of nominal and real yields. In a world of very low to zero yields, SA bonds look fantastically attractive and relatively cheap to dollar-based investors.

	Nominal Yield	Implied Real Yield
South Africa	**8.92**	**4.13**
Indonesia	7.26	3.79
Brazil	7.05	3.23
Mexico	6.88	3.16
India	6.70	3.04
Russia	6.90	2.62
Malaysia	3.33	1.85
Average	5.15	1.30
China	3.14	0.73
Chile	2.53	-0.07
Israel	0.89	-0.36
Poland	1.99	-0.55
Czech Republic	1.33	-1.09
Turkey	13.15	-1.16
Hungary	1.97	-1.19

Source: Bloomberg

As a dollar-based investor, when one invests into a local currency bond market, there are two major risks that one takes. Firstly, you take the risk that the yield at which you are investing does not offer a sufficient margin of safety in the event of further local fundamental deterioration, and secondly you are taking the risk that the currency depreciates to such an extent that it wipes all the yield from the bonds. The first risk is something that we have discussed at length in the past. We construct a fair value for 10y SAGBs, using the expected global risk-free rate (US10y), expected US/SA inflation differentials and SA credit spread. We use values of 2% (Normal US 10y rate), 3.8% (5.3%-1.5%) [SA 10y breakeven -US 10y breakeven] and 3.2% (SA EMBI Plus Sovereign Spread) to arrive at a fair value of 9.0%, which is not far from current levels of 8.9%. This suggest that SAGBs trade pretty much at fair value, implying not much room in the case of further fundamental deterioration.

Dollar-based investors have the option of buying a 10y SA bonds issued in dollars, currently trading at 4.9% with no currency risk or buying a 10y SAGB issued in rand trading at 8.9%. If you do not expect the currency to move, then it makes sense to buy the bond issued in rand due to the higher yield on offer. Over the last 20 years, the rand has depreciated by an annualized rate of 4.5%. The annual depreciation would comprise inflation differentials and risk premium. Since SA runs a higher inflation rate that the US, the rand has to deteriorate by a minimum of the inflation differential in order for purchasing power between the two countries to remain unchanged. The more unpredictable part is the risk premium that needs to be priced due to the risk of deterioration in other local factors. Over the last 20 years, inflation differentials between SA and the US has been 3.4% (5.6%-2.2%: actual inflation outcomes), suggesting the risk premium should be 1% (4.4%-3.4%). Current inflation differentials sit at 3.8%, which makes the 20y annualised depreciation of 4.4% look reasonable, as we assume a reduced risk premium going forward. This implies that a dollar-based investor can expect a return in dollars of 4.5% (8.9%-4.4%). Compared to the actual SA 10y dollar bond, this is not that attractive, unless one has a materially positive view on the currency. It would also explain why the local SA bond market has experienced outflows this last year of approximately R8b. This is a big turnaround from the R20b of inflows we were sitting with at the end of 1Q2019.

SA inflation will remain benign and growth subdued, which would, at worse, allow policy rates to remain on hold. However, persistently low growth and the need for further support of SOEs will weigh heavily on government finances, resulting in wider budget deficits and a significant increase in the debt burden. The global environment remains supportive for EM and SA, especially given the renewed monetary policy easing embarked on by global central banks. However, SAGBs trade at fair value at best and have a very limited margin of safety against a turn in global sentiment or a worsening in local economic conditions. Therefore, it is prudent to maintain a neutral to slightly underweight allocation to SAGBs at current levels.