CORONATION

STRATEGIC BOND STRATEGY

INSTITUTIONAL STRATEGY FACT SHEET AS AT 30 JUNE 2021

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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)	241.9%	208.7%	33.3%
Since Inception p.a.	9.5%	8.7%	0.8%
Latest 10 years p.a.	9.1%	8.5%	0.5%
Latest 5 years p.a.	8.7%	9.2%	(0.4)%
Latest 3 years p.a.	7.8%	9.2%	(1.5)%
Latest 1 year	16.1%	13.7%	2.5%
Year to date	7.1%	5.0%	2.1%
Month	1.3%	1.1%	0.2%

ASSET ALLOCATION

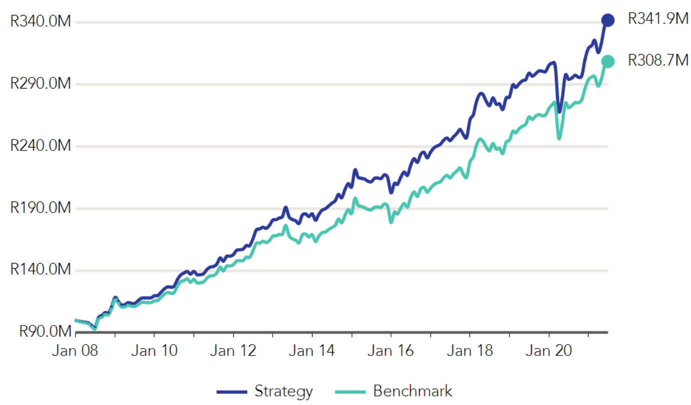
Asset Type	% Strategy
Fixed Rate Government Bonds	84.0%
Fixed Rate Corporate Bonds	6.4%
Property	3.9%
Corporate ILBs	2.9%
Fixed Rate Other	0.9%
Government ILBs	0.8%
Floating Rate NCDs	0.4%
Floating Rate Corporate Bonds	0.3%
Cash	0.3%
Floating Rate Other	0.1%

GENERAL INFORMATION

Inception Date	01 January 2008
Strategy Size †	R6.35 billion
Strategy Status	Open
Mandate Benchmark	JSE ASSA All Bond Index (ALBI)
Dealing Frequency	Daily
Base Currency	ZAR

†Strategy assets under management as at the most recent quarter end.

GROWTH OF R100M INVESTMENT



Benchmark: JSE ASSA All Bond Index (ALBI)

EFFECTIVE MATURITY PROFILE*

Term	% Strategy	% Benchmark
0 to 1 year	1.4%	22.7%
1 to 3 years	2.2%	6.0%
3 to 7 years	6.6%	18.7%
7 to 12 years	29.1%	24.0%
Over 12 years	56.8%	38.8%

STRATEGY STATISTICS*

	Strategy	Benchmark
Modified Duration (incl. inflation-linked bonds)	6.7	6.5
Modified Duration (excl. inflation-linked bonds)	6.6	6.5

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 all fixed interest assets. Nishan has 18 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 19 years' investment experience.

Seamus Vasey - BCom (Hons), MSc, CFA

Seamus is a portfolio manager and analyst within the Fixed Interest investment unit with 17 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.

DISCLAIMER

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

REVIEW FOR THE QUARTER

The Strategy generated healthy returns over the quarter, comfortably beating the benchmark, and contributing to the strong outperformance for the 12-month period. All asset classes have enjoyed very good returns over the last year, as they recovered post the onset of the Covid-19 COVID crisis.

South Africa's (SA) recovery has been elevated by the current global environment, translating into strong asset price performance. The rand is up c.3% against the US dollar this year, with most of that performance coming through in the second quarter of the year (Q2-21). This is broadly in line with its emerging market peer group (except Brazil, which has enjoyed a more significant recovery in its currency following the commencement of its pre-emptive rate hiking cycle), but what has set SA apart is the performance of its local bonds. Despite the yield on the 10-year bond being 30 to-40 basis points (bps) higher since the beginning of the year, the FTSE/JSE All Bond Index (ALBI) has returned 5.0% this year (6.9% over the 2Q-2021). This has been led by the strong performance of bonds with a maturity of >12 years, as the yield curve has continued to flatten. Inflation-linked bonds (ILBs) had a poorer quarter returning c.3% but remain ahead of ALBI returns, year to date (7.7%). Both ALBI and ILB returns remain well ahead of cash for the quarter (0.9%) and the year (1.7%).

June saw developed market central banks maintaining monetary policy rates and revising growth expectations upwards following increased economic activity and success in rolling out the vaccine programme. In emerging markets, a few central banks surprised the market with rate hikes as inflation pressure continues to rise.

In the US, the Federal Reserve Board (the Fed) left policy rates unchanged at 0.00% to 0.25% and maintained the size of the asset purchasing programme, as expected by the market. The post-meeting communication highlighted growth risks to the upside as economic data has positively surprised expectations. Importantly, though, the Fed turned more cautious on inflation, revising its 2020 forecast up to 3.4% from 2.4% at the previous meeting – although the gains are still deemed likely to be temporary. Headline inflation accelerated to 5% year on year (y/y) in May from 4.2% y/y in April. The uptick was the result of a combination of factors, including low base effects, increased energy prices and an extension of high used vehicle prices. Core inflation rose to 3.8% y/y in May from 3% y/y in April.

In emerging markets, China's headline inflation increased to 1.3% y/y in May from 0.9% y/y in April. The upward pressure came from a mix of factors, namely, increases in the cost of non-food goods, transportation, communication, clothing, and education. Core inflation increased to 0.9% y/y in May vs 0.7% y/y in April. Elsewhere in emerging markets, central banks in Brazil, Mexico, Russia and Hungary hiked policy rates as inflation concerns mount. Inflation pressures are seen to be on the upside, owing to base effects, increasing demand and rising commodity prices.

The rand was stronger over the quarter but weaker over June, in line with the performance of high yielding emerging market assets. This was further buoyed by positive developments on the growth and political front in SA, which helped the rand end the quarter at US$1/R14.28.

In the first quarter of 2021 (Q1-21), SA's GDP was stronger than expected at 4.6% quarter on quarter (q/q) seasonally adjusted annualised (saa), compared to a revised growth of 5.8% q/q saa in the fourth quarter of 2020. Positive contributions came from financial and business services, mining, manufacturing, transport and trade sectors. From the demand side, household and government spending slowed down but remained positive contributors to GDP, while inventories provided a strong boost as these were drawn down at a slower pace than before. The new restrictions could dampen third-quarter GDP this year, despite efforts made to limit the impact on the broader economy.

Headline inflation accelerated to 5.2% y/y in May from 4.4% y/y in April. Core inflation was stable at 3.1% y/y in May vs 3.0% y/y in April. The inflation uptick largely reflects base effects related to fuel and somewhat higher food and apparel prices. The South African Reserve Bank left rates unchanged in May, but more recent comments from Monetary Policy Committee members suggest some growing caution about the outlook for inflation.

At the end of May, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 6.07% (three-year) and 7.14% (five-year), significantly higher than the close at the end of the previous month. This was largely driven by expectations for higher inflation, reduced stimulus, and quicker rate normalisation speeds across global emerging and developed markets. However, SA's more moderate inflation expectations suggest that the current pricing of these instruments remains attractive due to their lower modified duration and, hence, high breakeven relative to cash. In addition, NCDs have the added benefit of being liquid, thus aligning the Strategy's liquidity with the needs of its investors, and thus generally has a 15-25% exposure. The Strategy continues to hold decent exposure to these instruments (fewer floating than fixed), but we will remain cautious and selective when increasing exposure.

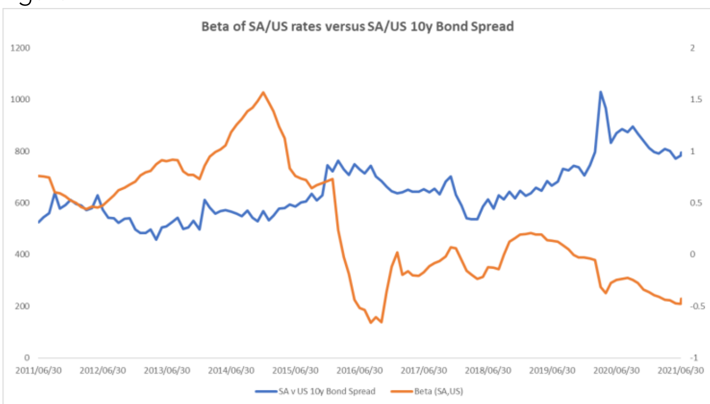
Global monetary policy normalisation will take the form of the tapering of bond asset purchase programmes, followed by a rise in policy rates. This will result in global bond yields moving higher over the next few years. Historically, the pace and magnitude of the rise in global bond yields have had significant repercussions for the local bond market. Currently, the US 10-year Treasury Bill (a proxy for global bond yields) is at 1.50%, and pricing in the forward market puts expectations for this rate to be at 2% to 2.25% over the next two to three years.

The magnitude of the move is not large by historical standards, although the pace of the repricing will remain unpredictable. Local bonds have generally had a high beta (a relative measure of volatility between two assets) with US 10-year bonds. However, the spread between SA bonds and US bonds are at historically wide levels, primarily due to the deterioration in SA's fiscal metrics. It is plausible that with SA's fiscal metrics recovering, this spread is too wide and should narrow, implying that even if US bonds were to sell-off, the equivalent sell-off in SA bonds should not be severe. As the spread has widened, the beta between the two assets has decreased; that is, the influence of US rates on SA rates has diminished. This suggests that the risk premium embedded in SA bonds should absorb a significant amount of the widening in global bond yields.

It is plausible that with SA's fiscal metrics recovering, this spread is too wide and should narrow, implying that even if US bonds were to selloff, the equivalent sell-off in SA bonds should not be severe. In Figure 1, we look at the rolling two-year beta of SA 10-year bonds to US 10-year bonds versus the spread between the two bonds.

It is quite evident that, as the spread has widened, the beta between the two has decreased; that is, the influence of US rates on SA rates has diminished. This further suggests that the risk premium embedded in SA bonds should absorb a significant amount of the widening in global bond yields.

Figure 1



Sources: Coronation and Bloomberg

In constructing robust portfolios, we must look for assets that provide us with some protection if the tail risk becomes a reality. ILBs provide portfolios with protection in the event inflation comes in higher than expectations. Currently, the real yields on offer are higher than longer-term averages, and the required actual inflation average required to provide a better return than nominal bonds is quite low in certain areas of the curve. Figure 2 shows the various ILBs on offer and the required inflation average required over the maturity of the bond to perform in line with their nominal bond equivalent. The longer the maturity of the bond, the larger the payoff symmetry; that is, if you are certain inflation will average above the minimum required level, it pays more to own the longer maturity. Our current expectations are for inflation to hover around 5% for the next 12 to 15 months, making ILBs out to 2029 quite attractive. Longer dated ILB's will have a better return profile, but the hurdle for them to outperform nominal bonds is significantly higher, making them less attractive.

Figure 2: Impact of inflation on inflation-linked bonds

Bond	Maturity	Current Real Yield	Inflation required to beat nominal bond	Current Nominal Bond Equivalent
R197	07 December 2023	1.3300	4.36	5.75
I2025	31 January 2025	2.2100	4.13	6.43
I2029	31 March 2029	3.1300	5.27	8.56
I2033	28 February 2033	4.0200	5.56	9.81
I2038	31 January 2038	4.2400	5.94	10.43
I2046	31 March 2046	4.2700	6.03	10.55
I2050	31 December 2050	4.2400	5.98	10.47

Sources: Coronation and Bloomberg

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The prospects for the local economy have improved as reform progress has gathered momentum, and global developments have provided tailwinds to the local recovery. Inflation is moving higher but should remain under control despite uneasiness around global inflation. The recovery in growth should gain more traction and spill into next year, which will provide more breathing room for the fiscus. SA government bonds (SAGBs), despite their recovery in Q1-21, still embed a significant risk premium relative to cash. The steepness of the yield curve makes the 12- to 15-year area attractive, even if the local rate hiking cycle starts sooner than expected.

The current steepness of the bond curve and high bond breakeven levels relative to cash suggests a limited passthrough of rising short rates (repo rate) into local bond yields. However, this is not a certainty. All previous periods of interest rate hikes in SA have had a knock-on effect in the bond market, resulting in higher bond yields. The current landscape/risk premium should however mean that the passthrough should be reduced. In an interest rate hiking cycle, shorter-dated bond yields are generally more sensitive to change in cash (repo) rates, while longer-dated bonds yields have a lower sensitivity.

The 5-year (R186) and 9-year (R2030) bonds will therefore generally be more sensitive to movements in the repo rate, and should experience a more significant move higher in yields than the rest of the curve in an interest rate hiking environment. We believe the 12- to 15-year bonds are attractive, and our analysis indicates that only in the event where all bond yields move higher by 2%, do the 12-year and 15-year bonds underperform their 5- and 9-year counterparts. This supports the case for holding bonds in the 12- to 15-year area of the curve, as it offers the most attractive return prospects if the repo rate is normalised over the next two years.

ILBs provide portfolios with protection in the event inflation prints higher than expectations. Currently the real yields on offer are higher than longer-term averages, while the actual inflation average required to provide a better total return than nominal bonds is below 5% for ILBs out to 9 years. Our current expectations are for inflation to hover around 5% for the next 12 to 18 months, making ILBs with a maturity of less than 9 years relatively attractive. The Strategy's exposure is concentrated in the 4-5 year area. Longer dated ILB's will have a better return profile, but the hurdle for them to outperform nominal bonds is significantly higher, making them less attractive than nominal bonds.

The local listed property sector was down 3% over June, bringing its 12-month return to 25.6%. Despite being a decent contributor to performance over the past 12 months, the asset class has been the largest drag on the Strategy's performance over the medium term. The balance sheet concerns coming out of the Covid-19 crisis have subsided somewhat as companies have managed to introduce dividend pay-out ratios (with some withholding dividends entirely) and sell assets. Going forward, operational performance will remain in the spotlight as an indicator of the pace and depth of the sector's recovery. We believe that one must remain cautious, given the high levels of uncertainty around the strength and durability of the local recovery. However, certain counters are showing value, given their unique capital structures and earnings potential. Fortress REIT (FFA) remains the Strategy's largest holding. The company remains well positioned to benefit given logistic and convenience retail focus. In addition, the A share structure ensures first bite of income and grows by lesser of CPI or 5%.

The FTSE/JSE Preference Share Index was up 3.8% over the quarter, bringing its 12-month return to 14.8%. Preference shares offer a steady dividend yield linked to the prime rate and, depending on the risk profile of the issuer, currently yield between 8% and 10% (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 of its associated 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 the risks emanating from the dislocations between stretched valuations and the local economy's underlying fundamentals. 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. 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.