CORONATION

ACTIVE BOND STRATEGY

INSTITUTIONAL STRATEGY FACT SHEET AS AT 31 MARCH 2021

CORONATION
TRUST IS EARNED™

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)	763.7%	645.7%	117.9%
Since Inception p.a.	10.9%	10.2%	0.8%
Latest 20 years p.a.	10.3%	9.6%	0.8%
Latest 15 years p.a.	8.8%	7.9%	0.9%
Latest 10 years p.a.	9.1%	8.2%	0.8%
Latest 5 years p.a.	9.1%	8.7%	0.4%
Latest 3 years p.a.	5.2%	5.5%	(0.3)%
Latest 1 year	16.6%	17.0%	(0.4)%
Year to date	(1.1)%	(1.7)%	0.6%
Month	(3.3)%	(2.5)%	(0.8)%

ASSET ALLOCATION

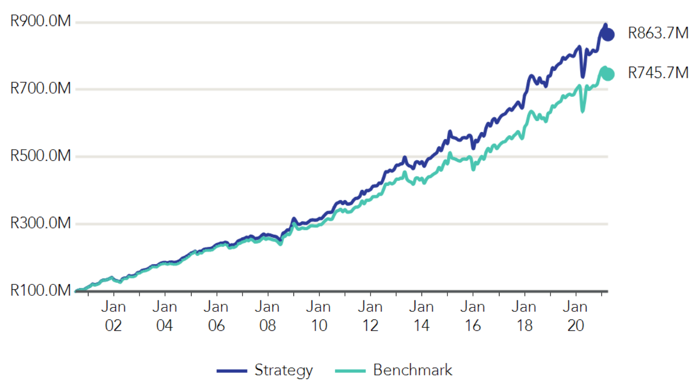
Asset Type	% Strategy
Fixed Rate Government Bonds	82.8%
Fixed Rate Corporate Bonds	4.8%
Corporate ILBs	4.1%
Cash	3.3%
Fixed Rate Other	2.4%
Floating Rate NCDs	1.7%
Floating Rate Corporate Bonds	0.7%
Floating Rate Other	0.1%
Government ILBs	0.1%

GENERAL INFORMATION

Inception Date	01 July 2000
Strategy Size *	R5.86 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	3.7%	22.7%
1 to 3 years	4.2%	6.0%
3 to 7 years	5.5%	18.7%
7 to 12 years	8.4%	24.0%
Over 12 years	78.3%	38.8%

STRATEGY STATISTICS

	Strategy	Benchmark
Modified Duration (incl. inflation-linked bonds)	6.9	6.3
Modified Duration (excl. inflation-linked bonds)	6.7	6.3

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.

Steve Janson - BBusSc

Steve is a portfolio manager and analyst within the Fixed Interest investment unit, with 14 years' investment experience. Steve's current responsibilities include fixed income and property research responsibilities as well as co-managing the Coronation Active Bond Strategy and Coronation Bond unit trust fund.

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

REVIEW FOR THE QUARTER

Progress is rarely made in a straight line and there are always bumps in the road, but, ultimately, what matters is the direction you are heading in. It is now just over a year since the World Health Organisation declared Covid-19 to be a global pandemic and the world went into lockdown. The difference now, however, is that we have several viable vaccines that will help stave off serious infection, lessen the pressure on healthcare systems and, hopefully, return our lives to some version of normality. There are concerns that new variants might reduce the efficacy of vaccines; that the vaccines might not be rolled out expeditiously; and that second, third and fourth waves will delay the global recovery. Ultimately, there is light at the end of the tunnel, and it doesn't look like another train!

South Africa remains precariously placed in the global recovery due to its stretched public finances, a glacial pace of reform implementation and the leisurely rollout of its vaccination program. Following a strong start to the year, South African government bonds (SAGBs) gave back a portion of their initial gains due to concerns that the large amount of global fiscal and monetary stimulus would stoke inflation, hence forcing a quicker normalisation in policy rates. The benchmark 10-year SAGB rallied to 8.75% by the beginning of February, but sold off by over 100 basis points (bps) by the end of the quarter, ending at 9.89%. This resulted in the All Bond Index (ALBI) returning -1.7% over the quarter, which was anchored by the underperformance of the 7- to 12-year area of the curve. SAGB yield movements were not dissimilar to the experience in many emerging markets around the world, as a reaction to c.80bps sell-off in US 10-year yields. Conversely, South African inflation-linked bonds (ILBs) produced a return of 4.6% in the first quarter as real yields held onto their gains since the beginning of this year. Due to March 2020 being the peak of the Covid-19 crisis in financial markets, the one-year performance of SAGB's and ILBs look spectacular at 17% and 16.7%, respectively.

Risks proliferate and remain high

South Africa's budget speech in February was an important road marker on South Africa's recovery path. Following better-than-expected tax revenue receipts, the National Treasury presented a picture of public finances that was much better than the October 2020 Medium-Term Budget Policy Statement, but still not indicative of debt stabilisation. It was very encouraging that the tax windfall was not used to increase expenditure in other areas, but instead used to reduce the borrowing requirement over the forecast period. This resulted in a reduction in weekly nominal fixed rate issuance by c.30%, which was welcomed by markets and resulted in the relative outperformance of the 12-year plus area of the curve, versus the 7-12-year bucket. However, implementation risk remains high as all the expenditure consolidation is focused on a three public sector wage freeze, which has already been rebuked by public sector unions.

In addition, State-owned enterprises (SOES) and other local municipalities are a further risk to expenditure given their poor health going into the Covid-19 crisis. Long-term austerity is not palatable in South Africa given the size of the expenditure adjustment needed to right the ship. To keep from sinking, South Africa needs to increase its potential growth rate by accelerating its reform process and bringing in the private sector.

There are early signs that the private sector is starting to contribute to investment but, for this to be sustained, policy needs to be transparent and stable. It is also essential that previous perpetrators of corruption are brought to justice to show that there are real consequences for malfeasance. Unfortunately, given the country's poor track record, investor confidence remains depressed, which is abundantly reflected in the elevated level of bond yields and the steepness of the yield curve.

Inflation is the key needle in the dial

The positive showing in the February budget should have resulted in an extensive rally and flattening in the South African bond curve. However, due to the sell-off in global rates, this was cut short and reversed. In January 2021, short-term inflation expectations in the US, as reflected by market implied breakeven inflation expectations (difference between US nominal and ILB yields), moved materially above 2%, peaking at 4% for one-year forward inflation and 2.5% for five-year forward inflation. Now, across all maturities, this sits at around 2.3% to 2.5%, which means that the market expects inflation in the US to average above the 2% average inflation target set by the Federal Reserve Board (Fed). This change in inflation expectations was driven by the Fed's change to average inflation targeting (i.e. targeting average inflation rather than aiming to keep it at a target point); the unprecedented level of monetary policy stimulus (zero base rates and the bond buying programme); and increased fiscal stimulus (approval of the Biden $1.9 trillion support package and the proposal of a further $2.2 trillion infrastructure spending package). The question facing many emerging market investors is if this repricing is sufficient and can emerging markets stomach these higher levels of US rates.

During the taper tantrum in 2013, financial markets experienced a similar magnitude of repricing in global bond yields which propelled emerging market and South African bonds yields materially higher. The reason for this was that fundamentally, emerging markets and South Africa were much more vulnerable to capital and portfolio flows given their large external funding requirements (reflected by the current account deficit), foreign ownership/involvement in local emerging economy bond markets were high, inflation was uncomfortably high, and valuations were full, if not expensive.

Navigating choppy waters

South Africa specifically is much better placed from an economic cycle and valuation perspective compared to the 2013 taper tantrum. US rates have had a significant repricing and, although the absolute level of 10-year rates remain quite low, the forward-looking expectations built into those rates suggest that they are adequately priced (barring any surprise shocks). SAGB's still trade relatively cheaply given that they still trade at multiples of cash, are among the highest yields in the emerging markets universe (both from a real and nominal perspective), the yield curve remains steep, and their embedded risk premium remains high due to the underlying fiscal risks. Although fiscal risks remain elevated, recent policy actions by the National Treasury and government have managed to buy us more time to right the ship, which makes the yields on offer even more attractive.

ILBs provide diversity to a portfolio given their low long-term correlation to nominal bonds (c. 50%) and offer protection against higher-than-expected inflation given that their outstanding principal grows in line with inflation. Despite the longer maturity ILBs trading at high real yields, these yields are not attractive compared to fixed-rate nominal bonds and have a low breakeven to cash because of their high modified duration (capital placed at risk to interest rate movements), making them an unattractive investment. However, the short-dated ILB (four years) provide an attractive opportunity, given the greater than 100bps yield pick-up relative to the equivalent nominal bond and, hence, higher breakeven to cash. We view this as an decent opportunity that provides diversity and an attractive yield pick-up.

Credit spreads in South Africa are back to levels seen pre-Covid-19. This suggests that credit fundamentals are as sound if not better post the pandemic fall out. Unfortunately, this is not the case and the contraction we have seen recently in credit spreads just mimics the global phenomenon of credit spread compression. Global corporate issuance levels are higher than they have ever been, but any yield pickup is being swallowed up since government bond yields are at zero and central banks are even buying corporate bonds in the secondary market. Locally, the situation is very different: government bond yields remain elevated (above corporate bonds even), there is no buying of corporate bonds by the central bank, and net issuance of corporate debt is declining as companies have pulled back on new investment activities. This reduced net issuance combined with the large amount of liquidity is the major reason for the compression of credit spreads. Underlying fundamentals remain negative, as bank credit loss ratios are elevated suggesting underlying stress in lending books and, hence, corporate South Africa. As bottom-up, valuation driven investors, we do not believe that the current levels of credit spreads offer sufficient compensation for the underlying risk and hence we would steer clear of corporate exposure at current spread levels.

Finding the balance

South Africa remains in a delicate balancing act. In the short-term, inflation will remain under control and growth will pick up, supporting a cyclically better economic outcome. However, the fiscal accounts are problematic given the high levels of debt. While the cyclically better economic outcomes have provided some breathing room, there needs to be an acceleration in growth enhancing reforms, more emphasis on reviving private sector confidence to encourage investment, and no deviation from current expenditure plans. The recent move higher in developed market bond yields has sparked concerns of a replay of the 2013 taper tantrum, however, South African bond valuations are much more generous now with a much-reduced external funding requirement. We view SAGBs as an attractive investment opportunity and would still advocate an overweight position relative to benchmark for a bond fund. In addition, we would also allocate to four-year ILBs and steer clear of corporate credit spreads at current levels.