CORONATION
TRUST IS EARNED™

Please note that the commentary is for the retail class of the fund.

The fund had a challenging quarter, returning -3.4%, mainly due to weak equity markets. The fund has performed well against its peer group over meaningful time periods.

The quarter was characterised by heightened volatility in global equity markets; firstly driven by concerns around the impact of rising global bond yields and more recently due to the growing risk of a US/China trade war. Against this backdrop, the MSCI All Country World Index ended the quarter down 1.0% in US dollars (+14.9% over a rolling 12 months). Emerging markets continued their recent outperformance, returning +1.4% for the period (+24.9% over a rolling 12 months) relative to developed markets which returned -1.3% (+13.6% over a rolling 12 months).

We continue to avoid owning global bonds given our expectation that bond yields will move higher. The global economy is experiencing a synchronised recovery with signs of inflation returning. This, coupled with central bank policy rates that we believe are still too low for a non-crisis global economy, and US President Donald Trump's tax package – which will provide further economic stimulus – makes it appear almost inevitable that interest rates will eventually have to rise to more normal levels. Naturally, this will have knock-on implications for the pricing of all risk assets and we would temper expectations around equity market returns relative to the strong gains we have experienced in recent years.

Locally, the good news post the ANC's elective conference in December has continued. Cyril Ramaphosa was sworn in as state president in February, followed shortly thereafter by a major cabinet reshuffle in which he made some credible appointments in certain key ministries. This decisiveness, together with a sound 2018/19 Budget, was rewarded when Moody's raised the outlook for South African sovereign debt from negative to stable and maintained the country's sovereign rating at Baa3, which keeps it in the Citi World Government Bond Index. GDP data for the last quarter of 2017 beat expectations at 3.1% quarter-on-quarter versus the market expectation of 1.8%. Improving inflation expectations gave the South African Reserve Bank room to cut the repo rate by 25 basis points to 6.5% and opened the door to further rate cuts later in the year. In terms of the post-Zuma governance clean-up: the National Prosecuting Authority announced that Mr. Zuma would now face corruption charges that had been dropped nine years ago and the South African Revenue Service head Tom Moyane, was suspended. Further, the newly appointed mining minister Gwede Mantashe, announced that he would revise the mining charter, a move welcomed by the mining industry. Although we have yet to see all this good news translate into improved corporate earnings, we are confident that the economy is once again headed in the right direction.

Given the improved political and economic outlook, the rand continued its December rally and ended the quarter 4.7 stronger against the US dollar and 2% stronger against the euro. Domestic bonds also had a very strong quarter with the All Bond Index ending up 8.1% – making South African government bonds one of the best performing, globally, for the quarter. Our low exposure to domestic fixed-rate bonds detracted from performance over this period. However, we believe that South African fixed income assets are currently fully priced and are reflecting much of the good news for the local economy. Furthermore, local bond yields provide very little cushioning against a further increase in global inflation and a rise in developed market bond yields. We therefore continue to maintain very low exposure to fixed rate bonds. This is partly offset by our overweight position in listed property – especially the A property shares, which we believe offer very attractive risk-adjusted returns.

Overall, the JSE had a poor quarter, with the JSE All Share Capped Index declining 6.0% (and with it dragging down its rolling 12-month returns to 9.6%). The weakness was driven by industrials (-8%) and property (-20%), with the latter being impacted by the collapse in the share prices of the Resilient group of companies, i.e. Resilient (-65%), Fortress B (-46%) and Nepi Rockcastle (-44%). This was on the back of allegations of management impropriety principally related to share price manipulation. Fortunately, the fund had no exposure to these counters. The financial sector continued its rally that commenced post the ANC elective conference with banks (+4.2%) and life insurers (+1.2%) ending the quarter in positive territory. The resources sector declined -3.8% with platinum stocks (-21%), in particular, having another terrible quarter. We have taken some profits on our offshore equity positions and added opportunistically to domestic stocks – thereby marginally increasing our domestic equity exposure.

We continue to maintain a reasonable exposure to resources companies based on our assessment of their long-term value. Our preference for Anglo American (+10%) over BHP Billiton (-3%) – based on a more attractive commodity mix and valuation – continued to contribute to performance for the quarter. However, our platinum exposure – mainly through Northam – has continued to be a detractor from performance.

The large mining companies have all recently reported results which were generally in line with, or better than, market expectations. The theme of strong cash flow, deleveraging and capital returns to shareholders continues. High prices, limited capital expenditure, benign mining inflation and low freight rates have led to the mining companies generating above normal free cash flow. We are starting to see mining inflation and capital expenditure levels pick up. In addition, growth is starting to make its way back into mining executives' vocabulary (examples include greenfields copper at Anglo American and coal acquisitions by Glencore). Our hope is that it remains measured and that these executives aren't lured into chasing growth at the expense of returns. News flow with respect to South African mining has also been distinctly more positive. Ramaphosa's election has brought much hope and optimism to the country. With his long history of involvement in the mining industry, the hope is that the sector's prospects improve. Indeed, one of Mr. Ramaphosa's first actions was to replace the mining minister (as noted earlier). In addition, new leadership has been injected into Eskom. In early April, the South African High Court issued a declaratory order, effectively recognising the principle of 'once empowered, always empowered'. Legal recognition of this principle would remove the risk of ongoing dilution of ownership for equity holders. Our expectation is that increased policy certainty, a reduction in patronage and politically induced safety stoppages should go a long way to improve the operating environment for our local miners.

The British American Tobacco (BTI) share price declined by 16% during the quarter – partly on the back of sector rotation out of global staples and partly due to regulatory concerns around the threat of the US Food and Drug Administration's intention to reduce nicotine consumption. This is not the first (and certainly not the last) time that tobacco companies will face regulatory headwinds in their markets. However, we continue to believe that these concerns are overblown and that the market is underappreciating the pricing power, stable earnings and cash flow generation inherent in the business. Furthermore, we are optimistic on the earnings opportunity from next generation products and the synergies that could be extracted from the recently completed Reynolds deal. BTI is currently trading on a 13.4x one year forward P/E multiple and 10.4x our assessment of normal earnings. This is incredibly cheap for a globally diversified business of this quality and we continued to add to our BTI position during the quarter. The share is now the single largest position in the fund.

Although domestic banks have had a strong run since December, Investec has been a standout laggard due to the market's preference for banks with more exposure to domestic South Africa in anticipation of a strong economic recovery. With respect to Investec, in addition to its South African bank, one is also buying a high-quality asset and wealth management franchise as well as a UK banking operation where the earnings base is currently low (and where there is upside optionality should they be successful in pursuing their UK private banking aspirations). Investec is currently trading on less than a 10x one year forward P/E multiple, c.8x our assessment of normal earnings and also offering almost a 5% dividend yield. We think the valuation is very attractive and added to our position during the quarter.

The UK property sector appears to be coming back to life after the economic uncertainty surrounding Brexit. Initially sparked by the Hammerson all share offer for Intu in December, Hammerson ultimately became an acquisition target in March following the French-listed REIT, Klepierre's, proposed cash and scrip offer. Although Klepierre's proposal represented a c.40% premium to the undisturbed Hammerson share price just prior to the announcement, we still believe that at a c.20% discount to Hammerson's recently reported NAV, the potential offer significantly undervalues Hammerson's equity.

Material changes to the fund's equity portfolio for the quarter included a further reduction in our Naspers position on the back of a very strong run in Tencent's share price. We also sold most of our position in Discovery – again on share price strength. We further exited our position in Foschini as the business was trading above our assessment of fair value. We currently have limited exposure to the South African clothing retailers given their stretched valuations. At this point our preferred domestic equity exposure are the defensive counters such as Netcare, Life Healthcare and the food retailers (i.e. Pick n Pay and Spar) where we think valuations are still attractive.

In this uncertain world, our objective remains on building diversified portfolios that can absorb unanticipated shocks. We will continue to focus on valuation and seek to take advantage of attractive opportunities that the market may present to us, and in so doing generate inflation-beating returns for our investors over the long term.

Portfolio manager
Karl Leinberger, Sarah-Jane Alexander and Adrian Zetler
as at 31 March 2018