CORONATION BALANCED PLUS FUND

Quarterly Portfolio Manager Commentary

CORONATION
TRUST IS EARNED™

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

The fund experienced a challenging quarter, with a return of -0.7%, mainly due to weak domestic equity markets. The fund has performed well against its peer group over meaningful time periods.

The MSCI All Country World Index ended the quarter up 4.3% in US dollars despite continued monetary policy tightening, trade war escalation and emerging markets jitters – primarily focused around Argentina and Turkey. The fund continues to take advantage of this heightened volatility across markets to invest where attractive return opportunities exist. Emerging markets continued their recent underperformance, returning 1% for the quarter (with returns now flat over a rolling 12 months) relative to developed markets, which returned 5.6% for the quarter (+12.3% over a rolling 12 months). Although the fund has benefited from its exposure to global equities, our overweight position in emerging market equities has detracted from performance. Notwithstanding this underperformance, we believe that our emerging market equity exposure currently offers compelling value.

In the US, on the back of continued robust economic growth and rising short-term rates, the US 10-year government bond yield ended above 3.0% at quarter-end (its highest level in almost seven years), lifting most developed market bond yields along with it. The Citi World Government Bond Index (WGBI) declined by 1.6% in US dollars for the quarter. The two-year rolling returns for the WGBI are now negative 2.2% per annum – a stark reminder that bond investments are not riskless. The fund has benefited from being underweight in global bonds. The US economy is notably strong (the unemployment rate just hit a 50-year low) and other advanced economies are still growing faster than long-term sustainable rates. This coupled with central bank policy rates that we believe are still too low for a non-crisis global economy, make it appear almost inevitable that interest rates will rise. We therefore continue to remain cautious on the outlook for global bonds.

The impact of tightening global financial conditions and US dollar strength has already been felt across a number of asset classes – especially in emerging markets, where domestic and external vulnerabilities have been exposed, and a number of emerging market currencies have demonstrated extreme volatility and depreciated significantly. The rand has not gone unscathed and depreciated a further 3% against the US dollar over the quarter, bringing the total depreciation to almost 13% for the year to date. Given the unfolding global macroeconomic environment, coupled with weak domestic economic fundamentals, the currency continues to look vulnerable.

Domestically, things remain very tough. The local economy dipped into recession with the second-quarter GDP number of -0.7% being well below the consensus expectations of +0.6% growth. Recent reporting by domestic consumer-facing businesses reflects this harsh economic reality, with numerous companies reporting results below expectations. In September, President Cyril Ramaphosa announced a new economic stimulus package which included several supply and demand side reforms aimed at both raising productivity and public sector-driven investment projects. These reforms comprise infrastructure spend projects, easing of work and travel visa requirements, employment tax incentives and market-friendly revisions to Mining Charter 3. Sadly, the local economy has many structural challenges and improvements are likely to take a long time to gain traction. Nonetheless, these initiatives are a step in the right direction. Against the backdrop of a very weak economy, the South African Reserve Bank was still able to leave the repo rate unchanged at 6.5%, as the inflation outlook continues to look relatively benign.

Overall, the JSE experienced a difficult quarter, with the JSE Capped Swix All Share Index declining by 1.7% (and with it dragging down rolling 12-month period returns to a paltry 0.4%). The poor returns for the quarter were driven by a weak performance from the industrial sector (-8%). The financial sector performed strongly – mainly driven by the life and non-life sectors which were up 12% and 17% respectively. The resources sector had another good quarter and was up 5% with platinum stocks (+26%) having a very strong three-month period on the back of a rising platinum group metals basket price.

With local bond yields ticking up, the All Bond Index returned only 0.8% for the quarter. We continue to maintain our very low exposure to fixed-rate bonds, with this position partly offset by our overweight position in listed property – especially the A property shares, which we believe offer very attractive risk-adjusted returns.

We continue to maintain reasonable exposure to resources based on our assessment of their long-term value. Our preference for Anglo American (+6%) over BHP Billiton (+2%) – based on a more attractive commodity mix and valuation – continued to contribute to performance for the quarter. Our platinum exposure – mainly through Northam (+9%) – also added to performance during the period under review. We took advantage of market volatility and opportunistically added to our Anglo American holdings during the period.

Naspers' share price declined on the back of a pullback in the Tencent share price. Tencent's recent quarterly earnings were disappointing and short-term earnings expectations have been revised downwards due to the restructuring of certain Chinese government departments and the subsequent delays in the licensing of new online games. Chinese authorities have also proposed new regulations around protecting minors from the adverse effects of online games, which has created uncertainty in the Chinese gaming sector. We believe the licensing delays will be a temporary disruption to the business. Furthermore, our interpretation of the new proposed gaming regulations is that they will favour strong, responsible incumbents like Tencent. As such we remain optimistic on the longer-term prospects for its online gaming business and are still very encouraged by the opportunities in growing its advertising, financial services and cloud businesses. In addition, Tencent has an outstanding investment portfolio, the value of which we believe is still very underappreciated by the market. In the case of Naspers itself, we are very encouraged by its management team's actions around portfolio optimisation and the steps taken to reduce the discount to its underlying intrinsic value. In this regard, management announced they would proceed with the unbundling of Multichoice – most likely to be completed in the first quarter of 2019.

The MTN share price declined after the surprise announcements by the Central Bank of Nigeria (CBN) and Nigerian Attorney General that MTN was in violation of certain foreign exchange control regulations and that MTN should repatriate $8 billion to the country and pay an additional $2 billion in back-taxes. These actions have created widespread uncertainty and is undermining the investment case for foreign investment in Nigeria. As the pressure of market forces has come to bear, the tone of more recent public announcements by the CBN has been less aggressive and more constructive. While these events were extremely disappointing, we believe a worst-case scenario is more than reflected in the current MTN share price (even with Nigeria at a zero value, we still see upside from current share price levels). Furthermore, we remain hopeful that rationality prevails and an amicable resolution can be found.

During the quarter, we continued to build a position in Quilter following its recent unbundling from Old Mutual. Quilter is a UK- focused integrated wealth manager. The UK savings market is substantial and the need for financial advice has increased dramatically given recent pension reforms which gives individuals more control over their retirement savings. This should act as a structural tailwind for the business. Quilter is very well placed with the second largest advice force and platform in the UK. It currently trades on around 13x one-year forward earnings and around 10x our assessment of normal earnings. This is a significant discount to its listed peers and we believe particularly attractive.

The fund's UK property holdings – primarily Intu (-13%) and Hammerson (-8%) - had another disappointing quarter mainly due to the economic uncertainty surrounding Brexit and, specifically in the case of Intu, concerns around its gearing levels. We are cognisant of the risks surrounding their investment cases, but nevertheless believe that these stocks are incredibly cheap. At quarter end, Intu was trading at a discount of more than 50% to its most recently reported NAV and offered investors a dividend yield of about 8% in pounds. Needless to say, this valuation dislocation has not gone unnoticed and after the failed offer by Hammerson for Intu earlier this year, it appears that Intu is once again in play after a consortium of investors - led by the Peel Group (Intu's largest shareholder) - confirmed that it is considering making an offer for Intu.
Some of our consumer-facing domestic holdings faced a very challenging quarter and experienced double-digit share price declines. At this point, we are asking ourselves whether the weakness is a cyclical or structural phenomenon. Has the earnings quality of food producers and retailers structurally changed? We don't believe this to be the case. In an economy with high structural inflation, it is extremely challenging for management to navigate a low volume growth environment. Only a small recovery in economic growth will significantly ease this burden. This issue has been exacerbated by the current low food inflation environment and, for producers, by additional imports on shelves because of a strong rand at the beginning of the year. As such, we believe some of these pressures will abate and continue to selectively add to the consumer stocks.

This has certainly been a testing quarter, but in this volatile and uncertain world, our objective remains on building diversified portfolios that can absorb unanticipated shocks. We will remain focused on valuation and will 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 managers
Karl Leinberger, Sarah-Jane Alexander and Adrian Zetler
as at 30 September 2018