CORONATION FINANCIAL FUND

Quarterly Portfolio Manager Commentary

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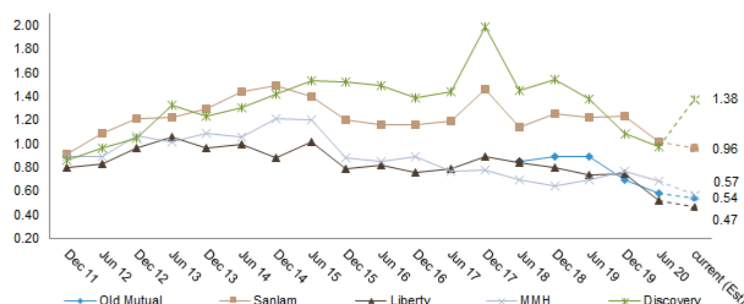
Please note that the commentary is for the retail class of the Fund.

Following a lacklustre third quarter of 2020, the final quarter of the year saw a strong rebound in financial stocks, with the sector returning 19.5%. Despite this rebound, returns for 2020 remain in negative territory, with the sector returning -19.7%, despite some recovery off the lows reached at the end of March (-37.8% year to date). It was against this backdrop that the Fund returned 17.3% for the quarter and -16.9% for the year. While the Fund was ahead of the benchmark for the year, the negative absolute return was inescapable, and negatively impacted longer-term returns, with returns of -8.8%, -1.9% and 7.3% per annum (p.a) over three, five and 10 years compared to index returns of -9.7%, -1.3% and 8.2%.

2020 proved to be a turbulent year, both for financial markets and for society at large, as countries grappled with the challenges presented by Covid-19. In response to the risks posed by the pandemic, unprecedented monetary and fiscal stimulus was unleashed and, following the initial sharp selloff in the first quarter, global markets recovered. The fourth quarter brought positive news, with several vaccine candidates subsequently gaining emergency use approval in the US and the UK by late December. Despite rising second-wave infections across many markets, this served to provide some light at the end of the tunnel, and global markets responded positively. The MSCI All Country World Index closed the year up 16.3% following a robust 14.7% return for the fourth quarter. The SA market lagged this performance with the FTSE All Share index delivering 1.9% USD return (7.0% in rand) for the year despite a strong 25.2% USD return (9.8% in rand) for the fourth quarter. In a year of very strong commodity prices, the resources sector outperformed our market delivering 21.2%, followed by industrials at 12.0%. Financials (-19.7%) were a significant laggard within the SA environment, a reflection of concerns around the potential impact that the Covid-19-induced current economic downturn is likely to have on this sector.

Within financials, Q4-20 delivered a sharp rebound for all sub-sectors, with banks strongest at 25.8%, followed by property (+22.2%) and the life sector (+14.1%). Annual returns were, however, negative with banks returning -17.7%, life companies -19.0%, and listed property -34.5%. During the quarter, the banks delivered operational updates which indicated that transactional activity had in many instances recovered to pre-lockdown levels, generally exceeding fairly bearish market expectations. The appetite for credit in the market was mixed, with some rebound in retail secured lending due to pent up demand, but corporate loan demand remained very soft. Loans that had been restructured early in the year to provide payment relief to customers during the lockdown appear to be performing well. The capital base at the banks remains strong and in keeping with our original expectations, and it is increasingly evident that the sector should be able to weather the Covid-19 storm without needing any capital injection. The banks may also be permitted by regulators to resume paying dividends sooner than had been anticipated by the market. Despite this, we believe risks to near-term earnings forecasts remain high. We are likely to see further job losses and company failures going forward and this is likely to impact on bad debts. In our view, banks have provided heavily for such an anticipated deterioration in June 2020, but the impact of a second wave may yet show this not to be the case. However, even taking such risks into account, the banks trade on what we believe to be undemanding, single-digit multiples based on our assessment of their normal earnings capacity.

In the current challenging economic environment, the life sector is likely to see decreases in persistency, weaker new business and increases in mortality claims. These trends are already evident in the numbers being reported and are likely to remain a challenge over the medium term. In response, life companies are bolstering reserves and rightsizing their costs to ensure sustainability. The fall in share prices we have seen now gives us the opportunity to purchase these companies at attractive levels relative to their intrinsic value. High-quality companies such as Sanlam have traditionally traded at a premium to their Group Equity Value (GEV), but can now be bought at a discount. Old Mutual, Liberty and MMH all trade at about half of their GEV, as shown in the chart below.



GEV= EV of life insurance operations + FV of non-life entities *Source: UBS*

The sector is well capitalised and generates strong cashflows, which should come back to shareholders in the form of dividends and/or share buybacks over time. Exposure to equity markets (where we see further upside) should further support future life earnings. At current prices, the sector trades on a high single-digit normal dividend yield with some prospects for growth for counters such as Sanlam, an attractive long-term investment.

While the property sector trades at large discounts to book value, this is a sector we do not believe offers an attractive risk-return profile. The sector is over-spaced, with a weak outlook for net rental income growth in retail and office portfolios. This is combined with the highly geared (and in some cases unsustainable) structure of their balance sheets. Prospects of making disposals to reduce debt are limited and, therefore, some property companies will require fresh equity capital to move to a more sustainable capital structure. Dividend payout ratios are also likely to re-set lower than we saw in the past to ensure adequate maintenance capital is retained over the long term. We remain underweight domestic property in the Fund as a result.

Relative performance for the quarter was negatively impacted by underweight positions in Capitec and property stocks Nepi Rockcastle PLC, Vukile Property Limited, Hyprop Investments Ltd, Redefine Income Fund as well as overweight positions in Quilter Plc, Ninety One Plc, RMI Holdings and Momentum Metropolitan Holdings. Contributors to relative returns included an overweight position in Nedbank Ltd as well as underweights in Remgro Ltd, Growthpoint Properties Ltd, JSE Ltd, and Old Mutual Ltd. During the quarter, we took the opportunity to add to Standard Bank, MMI and FirstRand, while reducing holdings in Capitec and Discovery.

The economic effects arising from the Covid-19 global pandemic are likely to be with us for some time, even with the vaccine successes achieved. Many companies have closed and may not re-open and some of the jobs lost are not likely to return. What was an already challenged, low-growth SA economy pre-Covid-19 is in an even more precarious position now. Many of the businesses in the Fund operate and derive a significant portion of their earnings from SA and will therefore not escape the pressures in the economy. Recovery will take time and for many companies, we do not expect to see a return to 2019 earnings levels until 2023 or 2024. What is encouraging, however is that there are many strong franchises in the SA financial sector, with strong competitive moats which we expect to endure over the long term. Over the course of the year, the Fund has increased its exposure to the high-quality businesses most likely to emerge from the pandemic in a stronger competitive position. Importantly, these franchises currently trade at levels that discount a significant amount of bad news and therefore provide attractive opportunities for the patient long-term investor.

Portfolio managers
Neill Young and Godwill Chahwahwa
as at 31 December 2020