CORONATION FINANCIAL FUND

Quarterly Portfolio Manager Commentary

CORONATION TRUST IS EARNED™

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

The first quarter of 2020 (Q1-20) marked the worst quarter for the JSE since 1998, and March the worst month since September 2008. This provides some context for the -37.8% returned by the fund for the quarter. While it is doubtless of little comfort to investors, this represented outperformance of the benchmark return of -39.5%. The performance of the last quarter has dragged the five-year return into negative territory, at -9% per annum (p.a.) and the ten-year annualised return to 5%. Benchmark returns over the same periods were -8% and 5.8%. Since inception, the fund has now delivered a compound annual return of 9.2%, ahead of the benchmark return of 7.5%.

The Covid-19 pandemic is, most importantly, a human tragedy that will touch us all in some way. Its impact on global economic activity has been heavily discounted across equity, fixed income, property and commodity markets around the world, and South Africa (SA) has been no exception. Our Chief Investment Officer Karl Leinberger has written at length on our thinking on its impact, as well as our approach to managing client funds in a crisis such as this. We don't intend to repeat those comments here, but instead refer you to the letter entitled 'Managing your capital through a time of crisis', available on our website. It does bear repeating, as we noted in our previous commentary, that in contrast to much of the developed world, SA has entered this crisis with an economy that is already in a parlous state, and a government that has limited tools at its disposal to mitigate its impact. The economic consequences of an as yet uncertain period of lockdown will therefore probably be felt that much more keenly and are likely to be longer lasting.

Unsurprisingly, the banks (-42.7%) and property stocks (-48.1%) performed most poorly, while the life insurers, although deeply negative, fared slightly better (-36.1%). To the extent that they don't receive support from governments, banks are the final stop when an economy stalls. When businesses are forced to cease operations, only those with strong balance sheets will be in a position to carry their cost bases for much more than a month or two in the absence of revenue generation. At some point, they will be forced into actions such as the cessation of rental payments, laying off staff, and rescheduling or defaulting on borrowings. This, in turn, has a ripple effect on those landlords and individuals who will similarly no longer be able to service their debts. Bank credit losses will rise and, given the heavily geared nature of bank balance sheets, this has the potential to impact significantly on earnings. This comes on top of an environment in which asset growth was already expected to be muted, interest margins under pressure, and non-interest revenue negatively impacted by weak levels of economic activity.

The South African Reserve Bank (SARB) has, thankfully, responded with a number of actions to alleviate some of the pressure on the banking system. It has acted to inject additional liquidity through various measures, including an element of quantitative easing. It has also provided guidance on how banks should provide for bad debts during a period of forbearance to customers, potentially alleviating some of the pressure on credit losses. In addition, it has relaxed liquidity and capital regulations, allowing the banks to operate at lower levels of both for a period of time, if necessary. These actions in combination should provide something of a cushion to the banks during this period of stress, but there is no doubt that a challenging time of uncertain duration lies ahead. The lack of certainty around the earnings outlook is reflected in severe declines in bank share prices (Nedbank, for example, lost 61% of its value in the quarter). However, it seems to us that the market is pricing in a scenario of capital raises by the sector. Given the highly uncertain environment in which we find ourselves, one cannot rule this out definitively. However, SA banks are well capitalised, and our work suggests that the probability of an event such as this is extremely low. This presents opportunities. Using Nedbank once again as an example illustrates the extent of pessimism: the share currently trades on 4 times 2019 reported earnings, a 13.7% historic dividend yield and 4.5 times our assessment of normal earnings in a post-Covid-19 world.

Contributors to fund performance relative to benchmark for the quarter were overweight positions in Quilter, Ninety One, Reinet, and Momentum Metropolitan Holdings, as well as not holding property stock Redefine. Detractors from performance were overweight positions in Nedbank, property stock Hammerson plc and EPE Capital Partners, an underweight in Sanlam, as well as the timing of purchases of Absa.

In March, Investec unbundled 55% of its 80% shareholding in the asset management business, now rebranded Ninety One. Management and staff own the remaining 20%. This is a business that we know and understand well, with an owner-manager culture similar to ours. Ninety One has evolved from a SA-based domestic manager into a genuinely global business, with close to 70% of assets sourced internationally. It has built a global distribution platform, consistently generated positive client cashflows, and has a strong performance track record. The business has a bias towards emerging market mandates, which should position it well for future flows, given the extent to which global asset pools are typically underweight emerging market cap weightings and benchmarks. While controlled by Investec, its attractive cashflows were typically trapped in the group, often to support the bank. But as a standalone business, the high dividend payout ratio will now pass directly to investors. While near-term earnings will be negatively impacted by the severe market declines experienced recently, the share trades on just less than 10.5 times our assessment of normal earnings, which we consider an attractive multiple for a high-quality business such as this. In addition to shares received in the unbundling, the fund subsequently acquired additional shares to take it up to a 4% holding.

During the quarter, we took advantage of some of the indiscriminate price action to increase holdings in what we consider to be high-quality businesses trading at attractive valuations, including Sanlam and Ninety One. We have continued to add to our holdings in Absa, as we now consider the risks in completing a successful separation from Barclays to be minimal and its efforts to rebuild its retail business are showing genuine signs of traction. To fund these purchases, we reduced the fund's holdings in Standard Bank, Old Mutual, FirstRand, Momentum Metropolitan Holdings, Hammerson and Discovery.

A very uncertain time lies ahead of us. The duration of the lockdown, and the likely drawn out return to normalcy, will determine just how severe the shock to our already fragile economy will be. The Moody's downgrade to junk at the end of the quarter, although widely anticipated, doesn't help. This is something that is exceptionally difficult to forecast with any conviction at this point in time. However, we need to remind ourselves that this will not last forever, and that normalcy (possibly a new normal) will return. Asset markets often present opportunities at times like these, and we continue to look for opportunities to invest in high-quality businesses at attractive prices, weighing risk against return, and with a strong focus on the long term.

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