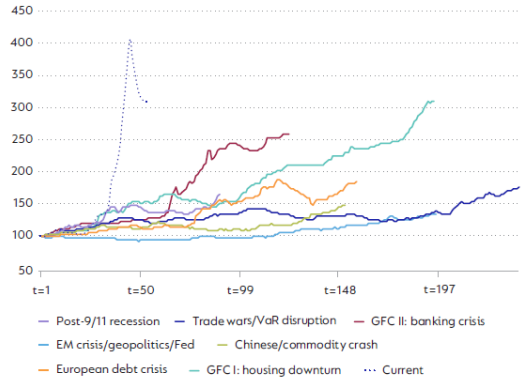
Please note that the commentary is for the US dollar retail class of the fund. The feeder fund is 100% invested in the underlying US dollar fund. However, given small valuation, trading and translation differences for the two funds, investors should expect differences in returns in the short term. Over the long term, we aim to achieve the same outcome in US dollar terms for both funds.

In last quarter's commentary, we wrote: "2019 was a year to make money". However, we also cautioned that "after a sustained period of strong equity returns, declining interest rates, reduced tax rates, expanding profit margins, and rising valuation multiples, investors should recalibrate return expectations lower. The conditions in place today are quite different to those in place a decade ago. We have no insight into short-term market moves, but feel that absolute returns could very well be lower over the next ten years compared to the last ten."

Well, we didn't have to wait long. Risk assets plunged over the quarter as the economic consequences of the Covid-19 pandemic started to become apparent. (For a full discussion, please see Coronation's commentary, available on our website). Economic activity in many countries and sectors around the world has come to a halt. This unprecedented 'full stop' caused stress and market dislocations across the spectrum. Volatility was back with a vengeance, and, in both credit and equity markets, indicators spiked to levels above those seen in the Global Financial Crisis.

Figure 1

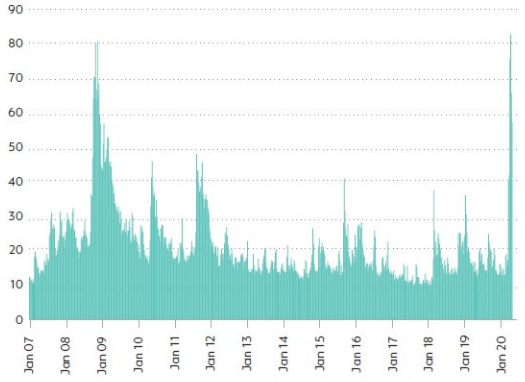
US INVESTMENT GRADE CREDIT SPREADS (RE-BASED TO THE START OF VARIOUS CRISES)



Source: ICE Bank of America

Figure 2

THE VOLATILITY INDEX (MEASURES EXPECTED VOLATILITY OF THE S&P500 INDEX)



Source: Bloomberg

With this as a backdrop, the Fund returned -9.7% for the quarter compared to 0.8% for the benchmark. It was a tough quarter for almost all asset classes: gold and government bonds being the only ones to deliver positive returns. Investment-grade bonds declined nearly 6%, high-yield bonds nearly 15%, and global equities 21%.

The major detractors were not, perhaps, what you would expect. Our equity portfolio was appropriately sized, selected and hedged. The negative contribution from equities was just over 5%. The stocks themselves performed in line with the overall market, and index level hedges reduced losses by a quarter. The Fund's fixed income holdings did not fare as well, declining by approximately 6.4% relative to a benchmark return which was roughly flat. Here, our lack of developed market government bond exposure was the primary culprit, as we had chosen instead to take some credit risk, which sold off as credit spreads increased. Importantly, these are mark-to-market losses, not permanent impairments, as we either still hold those securities or have rotated into issues with a more favourable risk-reward profile.

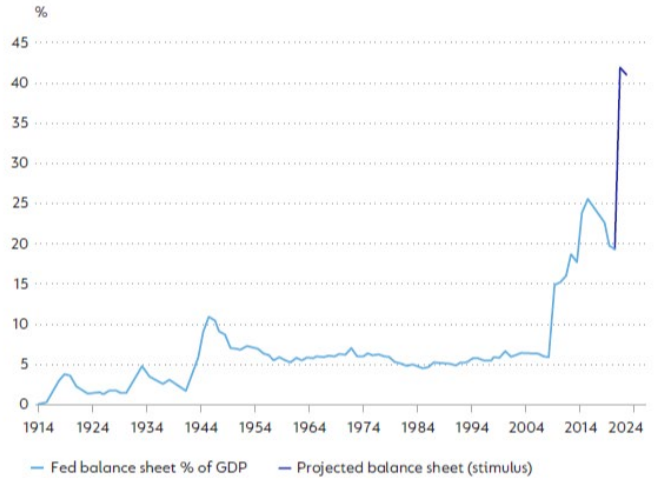
While the quarterly decline is disappointing, it should be considered in the context of:

- A very strong 2019 return of 14.1%, which was 10.2% ahead of the benchmark;
- Long-term returns which remain satisfactory (2.2% p.a. over 10 years versus the benchmark return of 1.6%; and
- A much-improved opportunity set, which is most important for potential future returns.

Following such a dramatic quarter, it is also worth reflecting on some of the additional aims for managing the Fund as outlined in last quarter's commentary. In particular the third point: *Do not expose the Fund to excessive risk, even if such exposures represent large asset classes which, in a normal environment, would be well-suited to a fund with this mandate (such as developed market government bonds today).* The fiscal and monetary response to the Covid-19 pandemic is unprecedented. Aggressive monetary measures are pumping vast amounts of liquidity into the system, causing central bank balance sheets to surge, while fiscal deficits are also set to explode once economic support is factored into government finances. Data for the US is shown below, but it is mirrored (to varying degrees) in Europe, Japan, China and the UK.

Figure 3

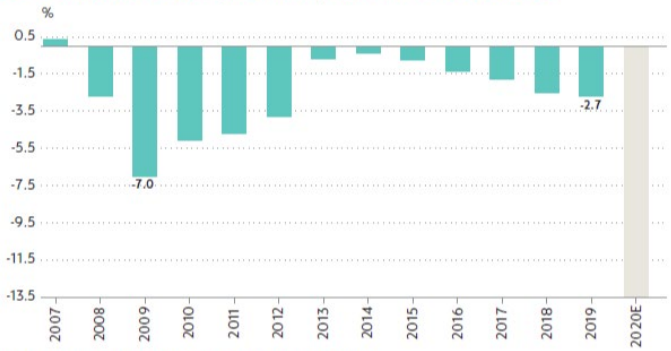
US FEDERAL RESERVE BALANCE SHEET (% OF GDP OVER LAST 100 YEARS)



Source: Bank of America Global Research

Figure 4

US PRIMARY BALANCE (% OF GDP, CYCLICALLY ADJUSTED)



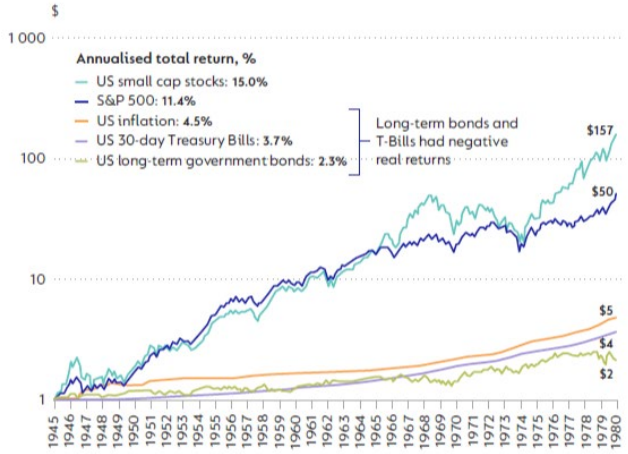
Sources: Haver Analytics, Morgan Stanley Research forecast

Notwithstanding the current recessionary conditions, which Morgan Stanley believes could be the fastest and steepest recession in history, resulting in spare capacity and economic slack, the world will eventually get back to work. From this low base of activity, pent-up demand (combined with huge stimulus) could be highly inflationary. In this scenario, the US experience after WWII is instructive and highlights the material underperformance, and declining purchasing power, of cash and government bonds (see chart below). This is in stark contrast to the last few decades, during which bonds have been the ultimate low volatility, low risk, uncorrelated, and real return-generating asset:

- Since 1990 (30 years), the global bond index returned 5.7% p.a., less than 1% behind global equities, with a fraction of the volatility and drawdown risk.
- Since 2000 (20 years), the global bond index has beaten equities by c.0.5% p.a.

Figure 5

CUMULATIVE TOTAL RETURN OF $1 FROM 1945-1980 AS OF 31 DEC 1980



Sources: Morgan Stanley Wealth Management GIC using data provided by Morningstar/©2020 Morningstar. Inc

As bonds approach the zero bound, the asymmetry of returns skews increasingly one way. Yields cannot be forever compressed, so the upside potential is limited (bond prices go up when yields go down). However, poor prospective returns from rates simply staying where they are, negative real returns from monetary debasement, and negative absolute returns from a rise in interest rates are all possibilities. While the inflationary scenario outlined above is only one potential outcome, it does inform the Fund's positioning and we continue to hold no developed market government bonds. In turn, we have built positions in assets that should perform well in an inflationary environment. Aside from the allocation to risk assets (equity, property and infrastructure), which comprised 37% of the Fund at quarter-end, we also have 11% of the portfolio in gold and inflation-protected securities.

Key portfolio actions

1. Active management of equity exposure

Walking through the changes in a volatile quarter such as this will help to illustrate the process. The quarter started with 30% effective exposure to equities. On 27 February, with markets not far off their highs (the MSCI All Country World Index was 522), exposure troughed at 25% as we grew concerned about the potential fall-out from the virus amid fairly widespread complacency in the market. Equity exposure peaked at 32.7% on 31 March (index level 442, c.15% lower). Considering the decline in the markets and the increase in exposure, one can see the Fund was a meaningful net buyer into the decline. While we will never time these actions perfectly, with a disciplined, rational process, and valuation philosophy that is rooted in the long term, we aim to have lower equity exposure when risks and valuations are high, and higher exposure when prospective returns are higher. Simple, but not easy.

2. Changes in equity holdings

There was a significant amount of activity in response to the market volatility. Earlier in the quarter, we exited holdings that had performed strongly and approached our estimates of fair value. Adidas, Blackstone and Apollo were all sold. On the purchases side, there were a number of strong businesses which became increasingly attractive as prices dropped over the quarter. We re-

entered Diageo, bought stocks such as Intercontinental Exchange and Thermo Fisher, and increased Unilever.

3. Other changes

Within credit, the most meaningful portfolio actions centred on investment-grade credits to take advantage of dislocated credit spreads (as shown in the chart above). Examples of near-dated issues that were purchased include:

- Berkshire Hathaway (AA-rated) August 2021s were bought at a credit spread of 250 basis points over Treasuries.
- GlaxoSmithKline (A-rated) May 2022s were bought at a credit spread of 290 basis points.

Outlook

Markets could very well remain volatile as the nature of the pandemic evolves and progresses. As a team, we are focused, as always, on researching individual businesses, assessing their long-term earnings power, understanding the potential impact this black swan event may have on the investment case, managing risk, and adjusting the portfolio accordingly. While the backdrop has changed dramatically, our process hasn't. Thank you for your continued support and interest in the Fund.

Portfolio managers
Louis Stassen and Neil Padoa
as at 31 March 2020