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The Global Quarterly

Land matters

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Notes from my inbox

"May you live in interesting times" – Chinese curse

By Kirshni Totaram

Kirshni is global head of institutional business. She is a qualified actuary and a former manager of the Coronation Property Equity portfolio. Kirshni joined Coronation in 2000.

THIS YEAR BEGAN with a political reboot in South Africa – 'Ramaphoria' has taken hold among both the local and international community. And rightly so. The main reason is that the country's leadership changes have taken place faster than expected and that president Cyril Ramaphosa has been able to act on difficult issues more quickly than even the most optimistic among us could have predicted. He has replaced a third of the cabinet and appointed respected and experienced individuals to key economic and policy positions. The process to shake up and transform the ailing public sector enterprises has also begun in earnest.

Part of the solutions introduced was a value-added tax increase from 1 April – the first in 25 years – a politically challenging decision but one that signals the serious intention to bring about change. This helped significantly towards South Africa avoiding a ratings downgrade as Moody's kept our investment grade rating >

unchanged and raised its outlook from negative to stable. Wow, what a turn of events!

But while all these developments are good news and steering things in the right direction, we know that our country has a long road ahead to correct the incompetence, corruption and lack of accountability of previous years. This is why the president has repeatedly made it clear that the righting of our country is a task for us all. But South Africans are resilient, we persevere and we muck in. These attributes will always help us prevail in the end.

We suspect we are in for a new era in the regulation of the technology giants, especially around data control and privacy.

Looking back is also nostalgic for us at Coronation as we mark our 25th year since launch. From humble beginnings, through years of working hard to earn the trust of our clients, we are proud of the meaningful role we play in the industry, managing the long-term savings of millions of South Africans and global investors. A big thank you to our clients for your support over the years.

And certainly, there is no way one can write about the last quarter without some words on the Day Zero threat that put Cape Town in the headlines around the world – but not for the right reason. The real and tangible implications of climate change are being experienced by millions of Capetonians who have had to change water consumption habits quite drastically over the past few months to fend off the crisis. The two-minute shower is a real thing – and boy, I must confess, is it hard. Thankfully, the efforts have been successful and Day Zero has been averted for 2018. Now all we need is rain!

Given the long sporting rivalry between South Africa and Australia, there is simply no way I could avoid speaking about the cricket cheating scandal which broke during the test match series between the two nations in March. For those of you who do not follow cricket, the ball tampering issue is akin to doping in cycling – it is a serious transgression in the sport. But perhaps the most notable matter for me is the commonality this moral transgression in leadership shares with many organisations – both in government and the corporate sector in the last while.

It is a reminder of the fine line between justifiable pride and arrogance, and of the importance of diversity in 'sounding boards' and decision-making groups. If you have a closed leadership grouping of individuals who always think the same way, some of the unchallenged ideas formed are bound to be bad. In the eye of the storm, they may even be ethically wrong. We talk about some of the failures in value later in an article on the audit profession.

Looking away from home, we certainly have not been short on news and activity this quarter. Volatility in the markets has returned – in a big way – and it looks set to stay. And on 6 February, SpaceX made history with a successful launch of Falcon Heavy, the most powerful commercial rocket in the world. The maiden flight also marked the first time a privately financed venture ever attempted to launch a rocket so powerful that it was capable of hoisting a payload out of Earth's orbit. And in keeping with what we have come to understand about Elon Musk, the Falcon Heavy was loaded with his cherry-red Tesla Roadster carrying a spacesuit-clad mannequin named 'Starman' in the driver's seat, broadcasting the tunes of David Bowie's 'Space Oddity'.

But all has not gone well for the technology giants. March concluded with a big fall in the well-known grouping FAANGs (Facebook, Apple, Amazon, Netflix and Alphabet's Google). A number of catalysts, including Facebook's Cambridge Analytica scandal, president Trump's attacks via Twitter on Amazon and well-publicised accidents involving self-driving cars, all contributed. The Facebook privacy scandal was a serious development. Facebook CEO Mark Zuckerberg's robotic and unconvincing testimony to the US Congress in early April was disappointing. The result is a corporate crisis and paves the way for potential political reckoning. And when things get nasty, they do so quickly – we saw even Facebook allies 'unfriend it' in the promotion of the '#DeleteFacebook' campaign. (Full disclosure here, I deleted my account. And yes, I did feel self-righteous in that moment). We suspect we are in for a new era in the regulation of the technology giants, especially around data control and privacy. It will be an interesting time as the internet moves into a whole new phase, Web 3.0

IN THIS EDITION

In this edition, we look at the very emotive and challenging issue of land reform in South Africa. Marie Antelme, Coronation's economist, offers insight into the open debate on land expropriation, how policy has evolved over time and what approach is needed going forward.

The article on the audit profession I mentioned also puts moral issues under the spotlight. We address the failures of audit firms to fulfil their roles as trusted guardians and the growing repercussions for their long-term relevance and survival. Neville Chester, a chartered accountant, covers this on page 9.

As the world embraces the dress code defined by athleisure, we delve into the global sportswear industry with an investment case for the world-class premium sports brand Adidas. As a counterbalance, we also share our view on British American Tobacco, a share which has been under enormous pressure in the short term but has delivered significant value for its shareholders over time, despite its highly regulated industry.

It is clear from our comparison of Vietnam and Egypt that everything that glitters is not gold. Vietnam's appealing macro environment does not translate into no-brainer investment ideas, while there are great opportunities behind Egypt's bad headlines.

The long-term economic challenges are serious here at home in South Africa. But growth last year was a little stronger than expected and this, coupled with our recent political changes, bodes well for an improvement in growth over the next couple of years. We hope president Ramaphosa and his new government can do enough of the right things to sustain it. It will be a welcome relief.

The current investment climate is far from traditional or normal. To survive and have our portfolios thrive in such an environment require a resilience to our investment approach that is strongly anchored on our core principles of being long term and valuation driven.

There is no doubt that this approach can lead to intense short-term performance pressures – as being experienced currently – but we also strongly believe that it offers the greatest opportunities, provided that one has a long-term perspective. Much of this is outlined and discussed in the articles in this edition. With the volumes there is to digest, we wish you a rewarding read! ✚

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POLITICS

Matters of land

Land reform under new leadership – both risk and opportunity

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By Marie Antelme

ALL ASPECTS OF land reform are complex and emotive. Throughout history and across geographies, people's ties to land are closely linked to their own cultural identity and economic position, and are often fraught with periods of upheaval. In South Africa this is profoundly complicated by our colonial and apartheid history, legacies that have always loomed large in government's approach to land reform. In the early 1990s, even the deeply divided negotiating parties recognised the importance of addressing land ownership as a critical condition of economic and social stability.

Land reform as a policy priority has had some successes, but also abject failures. This partly explains the calls for expropriation without compensation, but it is not the only reason. Years of poor service delivery, falling per capita GDP and widening inequality have all contributed to extreme social frustration, but the failure to distribute land more equitably is an obvious focal point. There is a political explanation, which also needs to be recognised.

The recent focus on expropriation without compensation, while critically important, detracts from the wider issue – the severely

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unequal distribution of ownership patterns in South Africa is undesirable and unsustainable, and has to change. However, any disorderly or confusing policy directives perceived to contest private property rights could quickly undermine both stability and growth. The enormous challenge for government now is to implement a programme of equitable land reform while containing the manner in which this is achieved.

In this short note, we cannot hope to address all the relevant and complicated issues that form part of the umbrella term 'land reform'. What we do hope to achieve is a better understanding of the context by which the ANC came to adopt land reform as a resolution after the elective conference at Nasrec in December last year. We look at the history of the ANC's land reform programme and offer some views on the path ahead for the new resolution.

LAND REFORM HAS ALWAYS BEEN AN ANC POLICY PRIORITY

In the early 1990s, after a number of failed negotiations, the 26 parties of the Multi-Party Negotiating Process agreed the priorities that would ultimately be the framework for the national constitution. The highly unequal distribution of land ownership was widely recognised as a key legacy of the past, and one which directly contributed to broader issues of wealth and power concentration, and entrenched rural poverty. Despite this, negotiations were protracted and heated, resulting in intentionally vague wording in the final draft, which was left open to judicial and other interpretation.

The institutional framework for land reform was entrenched in the Bill of Rights in the Constitution in the 'Property Clause' (Section 25). This includes three rights to land – equitable access, tenure security and restitution. It provides for the protection of property rights as well as the expropriation of land for both 'public services' and in the 'public interest' for 'just and equitable' compensation.

Land reform falls firmly in the 'public interest' provision and 'just and equitable' compensation takes into consideration the full history and use of the land in question, possibly allowing compensation from zero up to market price. The 1913 Land Act was intentionally included as the starting date against which both the right to restitution and the right to secure tenure were to be measured.

Land reform was identified as a key programme to be adopted by the incoming democratic government, with multiple objectives of delivering restitution for dispossession, driving rural development, creating jobs, raising income, and alleviating poverty and inequality. The potentially positive wider impacts of land reform were thus strongly emphasised from the outset. The ANC government embarked on an ambitious land reform programme early in 1994. It had three component programmes which were intended to be complementary:

1. The land redistribution programme to broaden the black majority's access to land. The target was 30% of land in the first five years.
2. The land restitution programme to restore land to or compensate people dispossessed of land as a result of racial discrimination after the 1913 Land Act.
3. The tenure reform programme to secure the rights of people living under insecure arrangements on land that they did not own, including land owned by the state (including former homelands) and by private individuals, including farm land.

To deliver redistribution, the Constitution provides for the state to 'take reasonable measures' 'within available resources'. This is an important condition to remember, as it informs the new policy debate.

LAND REFORM UNDER THE ANC: SUCCESS AND FAILURE

Early progress with land reform was slow. From 1994 to 1999, various laws were passed to build a consensus on land reform, and restitution claims were submitted to a deadline of December 1998. The focus was primarily on helping the poor. A total of 63 455 land claims were lodged, about 88% of which were by individuals or groups in urban areas. An audit showed that some of the claims were 'bundled'; the number of claims was therefore revised up to 79 696 in 2007. By March 1999, only 650 000 hectares (less than 1% of private farmland) had been transferred under various pilot schemes aimed at funding groups of people to enable commercial operation of transferred farms. Some progress was made with early legislation to ensure security of tenure (mostly halting illegal evictions), but this then stalled and has never recovered.

During Mbeki's presidency from 1999 to 2009, the pace accelerated. The focus shifted from meeting the land needs of the poor to the transformation of commercial farming. The land redistribution target of 30% was moved to 2014. By the end of 2009, government reported that 3.04 million hectares had been transferred to 185 858 beneficiaries. The restitution programme had settled 75 787 claims by that time, most of them urban, and most of these saw claimants compensated for property. Some 1.5 million people benefited.

However, problems dogged all the programmes. Official processes were incredibly slow and there was poor coordination between departments, with Agriculture and Land Affairs often passing regulations in conflict with each other. Some of the provisions in the regulations made both transfer and management of farms problematic. Grants had to be pooled to buy large tracts of land, but subdivision was not allowed. Technical support for emerging farmers was woefully inadequate and many thriving commercial farms failed. Corruption and collusion by both private and public entities were rife.

By 2009, land reform was perceived to be in deep trouble and public opinion plummeted. With the global financial crisis and domestic recession, the state had also started to run out of financial resources to fund it. A number of diagnostic investigations suggested that government had not used 'reasonable measures' or 'available resources' to their full extent or aggressively enough in delivering bigger transfers or finalising restitution claims.

The period from 2009 to date was characterised by a considerable slowing in delivery as well as a substantial increase in rhetoric

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and associated legislation about the importance of land reform, not least with the emergence of the Economic Freedom Fighters (EFF) in the 2014 elections. The raft of new regulations passed during this time complicated the land reform programme enormously. Importantly, a new Expropriation Bill was introduced in 2015 and approved in 2016. It aims to bring legislation governing expropriation, currently dating back to 1975, and applicable only to 'public use', in line with the Constitution. It also gives clarity to the 'just and equitable' provision in the Constitution, which may be an elegant way of circumventing any debate about needing to change the Constitution. The Bill has not yet been enacted.

Within this context, the ANC formally adopted land reform without compensation as a resolution at its elective conference in December 2017. It is very clear that 24 years after the initial programme started, the slow pace of progress on all three programmes has been an increasing source of frustration for many people who are still landless, impoverished and extremely vulnerable. The situation is exacerbated by mounting discontent with very weak general service delivery, the very low level of economic growth prevailing over the past 10 years, falling real per capita GDP seen over the last five years and associated rising inequality.

Prioritising this more populist approach to a long-held policy also has a political aspect. First, the ANC has captured the radical rhetoric of EFF leader Julius Malema, providing the opportunity to both deliver on this priority and manage the way in which the programme is implemented. Secondly, expropriation was championed within the ANC by the losing presidential candidate, Nkosazana Dlamini-Zuma. By formally adopting this resolution, her backers have leverage over the president in terms of delivering on this policy. What we do know, however, is that this issue is combustible, and if it is not contained in a rigid policy framework, it could have severely damaging socioeconomic consequences.

WHAT IS THE LIKELY PATH FROM HERE?

Time is of the essence. Government needs to put a framework in place that can deliver effectively and transparently both land and/or title to landless people on some scale, before the process becomes disorderly. It also urgently needs to manage the parameters of how a new programme is communicated.

There is little concrete by which to assess the new approach to land reform, but there are a few things we do know. The first issue to clarify relates to a resolution passed by parliament – in February, the National Assembly passed a motion to review the Constitutional provision for the expropriation of property (land) without compensation. This was not the original, more extreme, motion brought by the EFF, which called for an amendment of the Constitution, but rather a commitment to review the provision. This was approved by 241 votes to 83. The Constitutional Review Committee has until 30 August to report its findings and make a recommendation to parliament.

There is considerable legal debate about whether or not 'just and equitable' compensation could already be interpreted to include zero compensation, but it is necessary for this to be decided once and for all. Even a recommendation to change the Constitution may not guarantee it passes, because an amendment needs a two-thirds majority in the National Assembly, which means the ANC will need the EFF's backing. At this stage it is clear that the two parties have very different views of how a policy of expropriation of property should look.

Next, it is clear that any new policy will also not just be about agricultural land; it will be about all land, public and private. The state, and state-owned entities, hold vast tracts of land that can be utilised. Throughout the land redistribution programme, the state has been accumulating farms (estimates suggest 4 500 to 5 000 farms are owned by government) in addition to urban and peri-urban land. President Ramaphosa has called for an audit to accurately identify government land which could be used to establish a precedent. In addition, inner-city absentee landlord properties and private land on which there are established informal settlements could be opportunities to invest, improve the quality of infrastructure and establish ownership.

Government needs to strengthen the legal framework within which a new programme will operate. There are few judicial precedents of challenges to compensation policies for land transfer. Thus amending and expediting the Expropriation Bill (2017) may provide clarity and help establish some jurisprudence.

Lastly, the process needs buy-in. Both president Ramaphosa and ANC veteran Jeremy Cronin have committed to extensive consultation. It is clear that many people are angry, or frightened by the proposals, but also that the current situation is unsustainable. Clearly stating the conditions under which expropriation without compensation may be used, possibly on a case-by-case basis, could help rationalise the debate. Focusing attention on assisting the very poor and vulnerable linked to other efforts to reduce poverty might strengthen social commitment.

CONCLUSION

The critical and sensitive nature of land reform in South Africa demands strong leadership, clear principles to follow and efficient, consistent implementation with visible lines of accountability. Should South Africa fail in this undertaking, it would leave us vulnerable to the kinds of populism that can lead to chaos.

Land restoration in practice is unlikely to be possible in all cases and it will take competent leadership, which has been sorely lacking, to communicate that appropriately to communities. It is important that a moral purpose is instilled in the process, as the implementation requires sensitivity and respect between South Africans of different backgrounds. In many circumstances, financial settlements are the only way to compensate people. This compensation can only come from the government, given that land ownership may have changed hands numerous times over the years.

For a lasting solution, we need to recognise the different spiritual and cultural needs of South Africans to reach mutual understanding. While the concept of land ownership is complex, speaking not only to material needs but also to the spiritual significance of specific land, at its heart is restoring dignity and cultural rights to our people. ✚

Who guards the guards?

The relevance of auditors in a post-financial scandal world

By Neville Chester

OPEN THE NEWSPAPERS virtually any day of the week, or google 'auditor scandal', and you will be inundated with articles describing the failure of auditors, locally and globally, to achieve the objective of their function. The way markets have reacted to the failure of audit firms to meet their clients' expectations is in stark contrast to almost any other industry. Globally, companies which sell products or services that fail to live up to expectations are punished and often end up going out of business. Despite the constant failings of the audit profession at providing the users of financial statements with what was asked for, it survives and thrives. However, the backlash is building, as much globally as we have seen locally, against these trusted guardians whose important role in verifying information, systems and controls is the foundation of the corporate system.

Neville is a senior member of the investment team with 20 years' investment experience. He joined Coronation in 2000 and manages Coronation's Aggressive Equity strategy.

* *Satires of Juvenal, 1st century AD*

In 2001, the world was exposed to the last major failing of an audit firm where any measure of accountability was taken. Arthur Andersen, one of the then 'Big Five' audit firms was found to have failed to identify vast, fraudulently overstated revenue at the energy trading business Enron. The much-publicised shredding of working papers by Arthur Andersen staff in an attempt to frustrate investigations amplified the fallout. Since then, the remaining Big Four have held a virtual monopoly over the audits of major corporations around the world, and despite many audit failures, the same situation with the same Big Four prevails, with little evidence that audit outcomes have improved.

In South Africa, there was justifiably outrage over the discovery that KPMG had presented a report to the South African Revenue Service, which it subsequently withdrew as being inappropriate. It was also found that the audit firm had an inappropriate relationship with the Gupta family before firing them as a client in 2016. Subsequently, the reaction against the auditors of companies where there has been fraudulent representation over many years has been more muted, bizarrely so given the billions that have been lost as a result.

Deloitte is currently giving evidence in defence of its African Bank Investments Limited (ABIL) audit, and is likely to be investigated for its role in Steinhoff. Before the ink was dry on the draft copy of this article, two further audit scandals came to light. First, PwC provided internal audit services and KPMG provided an external audit to VBS Mutual Bank where it now appears there was significant fraudulent activity, resulting in its 2017 accounts being withdrawn. Secondly, the amaBhungane Centre for Investigative Journalism discovered that the audit firm Nkonki had been bought out by parties related to the Guptas. Soon after, the firm and its chosen partner in this case, PwC, received significant consulting work from Eskom on very favourable payment terms.

The only possible reason that the rush by companies to fire KPMG as their auditors has not been matched by similar moves against other audit firms is the stark realisation that there is not much choice. Listed companies and their investors have always preferred their audits to be conducted by one of the prestigious firms, believing that these firms had the capacity to undertake complex audits, were more likely to be independent given their much larger fee base and brand reputation, and attracted better quality employees due to their stature. While these factors do hold true, sadly this does not seem to be any guarantee of an appropriate audit being conducted. Simply firing one of the Big Four auditors and appointing a small audit firm does not make the problem go away. If this audit then becomes the firm's largest revenue client, it still challenges the argument of independence, as over-reliance on any one client is likely to cloud such a firm's judgement.

External auditor/statutory auditor:
An independent firm engaged by the client subject to the audit to express an opinion on whether the company's financial statements are free of material misstatements, whether due to fraud or error. For publicly traded companies, external auditors may also be required to express an opinion over the effectiveness of internal controls over financial reporting.

Despite the shadow hanging over the Big Four, their dominance continues to grow. Grant Thornton, the fifth-largest firm in the UK, recently announced that it is pulling out of bidding for large UK audits given the dominance of the Big Four and the firm's lack of client wins. Facing the prospect of bidding costs of approximately R5 million and perpetually being excluded in favour of the Big Four, they have made the rational economic decision to stop participating, leaving investors the poorer for choice.

While the problems are multiplying, the solutions are not obvious. We face the centuries-old challenge, alluded to in the title, of who will hold these guardians accountable for their own failures. Thus far, it has not been the independent regulatory bodies. South Africa's regulator of the auditing industry, the Independent Regulatory Board for Auditors (IRBA), is only now getting around to investigating the ABIL audit, and is woefully understaffed to deal with the number of challenges it currently faces.

In order to be an audit partner, you need to be a registered accountant. The South African Institute of Chartered Accountants (SAICA) has yet to publicly rescind the use of its designation by members implicated in the recent KPMG, ABIL or Steinhoff scandals. Groucho Marx famously said, "I would never belong to a club that would have me as a member". As a member of SAICA, and given the company that I share, I question why I would want to remain a member. This does not appear to be a solely South African problem. In the UK, it took the Financial Reporting Council, that country's accounting oversight body, 10 years to review KPMG's audit of HBOS bank, which failed during the financial crisis. KPMG was found not guilty.

Reinforcing the global angle on audit failure, the *Financial Times* highlighted a recent report from the International Forum of Independent Audit Regulators indicating that global accounting watchdogs had identified problems at 40% of the audits they inspected in 2017. The most common issue identified by these regulators was a failure among auditors to "assess the reasonableness of assumptions". The second biggest problem was a failure among auditors to "sufficiently test the accuracy and completeness of data or reports produced by management".

There is clearly a problem. The issue is how do the users of financial statements resolve it? It will be especially challenging for individual entities to drive the change necessary, given that it is a global problem and outside of regulatory intervention.

The first step we are taking as an organisation is enforcing the mandatory rotation of auditors in the companies in which we invest. While there is already pushback from the companies on this course of action, we think it is the only way to impose some measure of accountability on audit firms. Having a new firm come in and assess the state of reporting and controls with a fresh eye should encourage the incumbent auditor to ensure that its review is up to standard. By allowing a maximum tenure of 10 years, this avoids the additional costs and administrative burden of changing firms too often. The common view that the cost of changing audit firms is too >

burdensome on the companies involved is spurious, considering the cost to investors of fraudulent activity.

The other benefit of mandatory audit firm rotation is that it should change behaviour in asserting the link between the users of financial statements and those that prepare them. For too long auditors have behaved as if the company is the client, whereas in fact the client is all stakeholders who use the financial statements. The auditors need to be cognisant that they are appointed by shareholders, not the executive of the company, and should be beholden to provide them with a quality service.

A problem that is evident from pursuing mandatory audit firm rotation is the limited choice available, with the Big Four dominating the sector. The challenge of growing more competition will require more work and thought by shareholders and regulators. There is an element of a circular argument which needs to be solved. Smaller audit firms do not have sufficient skilled resources to complete the audits of large listed companies. However, they are not prepared to hire more resources if they do not have the client base, and there is no guarantee that they will get the clients once they have hired more staff. In addition, it is best for multinational companies to be audited by a single audit firm rather than by a number of smaller firms working within a global network, to reduce the risk of 'passing the blame' between audit firms. In order to break this circle, we need to see stakeholders undertake in advance to move audits to a Big Five or Big Six firm, or a regulatory body like the stock exchange or the IRBA to force the random selection of a firm from pre-approved auditors.

While some of these options may seem onerous and unfair, we should remember that the entire auditing profession exists because of a regulatory requirement that a company has audited financial statements. Their ability to generate returns is due to a regulatory mandate. To tweak this regulation to ensure better outcomes for stakeholders is not an unfair request.

The second issue that needs to be dealt with is the regulation of the industry and its participants. Without a doubt, the oversight of the auditing profession needs to be improved. While a statutory oversight body (the IRBA) exists, the fact that the failings have been so many and so widespread implies it is not succeeding. Improved resourcing is undoubtedly required and a more proactive, rather than reactive, stance needs to be taken. We must also consider those who prepare the financial statements and what level of oversight is required. There is strangely absolutely no regulation over who can prepare the financial statements of a listed company. The only requirement is that "the audit committee must, notwithstanding its duties pursuant to Section 94 of the Companies Act consider, on an annual basis, and satisfy itself of the appropriateness of the expertise and experience of the financial director".

Another issue to consider is the structure of the audit firm. The auditing profession has always avoided the corporate structure and has been structured as a partnership. Having personal liability was supposed to make the partner more accountable. But it does not seem to have worked. While a global brand is used worldwide, accountability and responsibility rest only in the localised regions, preventing aggrieved investors from accessing the global audit firm's resources. Properly ensuring consistent standards for global auditing firms should be seriously considered so that the entire group can be held accountable for failures. This would drive greater monitoring and compliance within the organisation, as opposed to today's system where there is very little incentive for the global organisation to monitor its regional operations closely.

In addition, the corporate governance of auditing firms should be addressed. They do not have an independent board overseeing how their operations are run. After the recent lapses at KPMG, the firm has introduced the role of an independent chairperson and a lead independent director. This should become standard for all firms auditing listed companies and state-owned entities.

The regular response from the audit firms to challenges to the status quo has been to complain about how much this will cost them. The reality is we have very little insight into the finances and profitability of these monitors of corporate reputability. It is ironic that those tasked with ensuring transparency in financial reporting are themselves inscrutable organisations where profitability and executive pay are often not in the public domain. Requiring audit firms to report their accounts will help the users of their services to determine the profitability of this industry and of the ancillary services and consulting work that they undertake.

There is a large lobby that believes part of the solution is to break up the firms into separate auditing and consulting operations. I am not in favour of this option, as I think the provision of consulting services makes the businesses more sustainable and helps to attract the right talent. However, what should be in place are strict rules around limiting the ability of current auditors to consult to and audit the same group, and appropriate cooling-off periods between providing these different services. The practice of loss-leading on the audit to gain a foothold into the organisation to sell more lucrative additional services should also be examined, as it potentially prevents non-consulting audit firms from being competitive.

The fact that so many organisations, tasked with the important societal role of confirming the accuracy of company accounts, are either complicit in fraud or unable to identify inappropriate controls and accounting policies is truly breathtaking. Over the past 10 years, as white-collar crime has soared alongside state capture and theft of public assets, it appears that the entire country's moral compass has shifted. What is required is a complete reset of values and a strong sense of accountability among members of the profession. The very definition of profession is 'any type of work that needs special training or a particular skill, often one that is respected because it involves a high level of education'. It is time that the auditing profession starts to show us how it will once again earn our respect. ✚

British American Tobacco

Thriving in a highly regulated industry

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By Siphamandla Shozi

BRITISH AMERICAN TOBACCO (BAT) is one of the world's leading tobacco and next-generation product (NGP) groups managing an extensive portfolio of brands. It has delivered earnings growth of over 10% per annum in constant currency over the last decade, a feat that ranks with the best in global staples. Shareholders have been rewarded with a dollar return of 9% per annum over this 10-year period, strongly outperforming the MSCI World Index return of 6.5% per annum over the same period.

This excellent track record has been achieved despite severe tightening of smoking regulations around the world. Not many businesses can operate, let alone thrive, in the midst of unfavourable regulations that include bans on public smoking and advertising, and plain packaging (effectively a ban on branding). BAT's performance is testament to the robustness of its business model.

PRICING POWER

There are not many businesses with true pricing power. BAT has the ability to pass through pricing ahead of inflation significantly

Siphamandla is a portfolio manager within the South Africa-focused investment team. He co-manages the Coronation Smaller Companies Fund and has research responsibilities across a range of South African stocks.

more than the average company due to the addictiveness of its product. Pricing is a key lever needed to offset declining volumes caused by fewer smokers. Regular increases in excise/sin taxes also contribute to frequent price increases being passed on to consumers. Over the past decade, BAT has been able to generate, on average, 6% per annum in pricing, resulting in low to mid-single digit revenue growth.

MARKET SHARE GAINS, COST SAVINGS AND MARGINS

BAT has consistently gained market share over the last seven years, driven by its strategy of pushing through global drive brands (GDBs) to replace a plethora of local brands with less market appeal. GDBs include familiar brands like Kent, Dunhill and Rothmans. GDBs have grown at 7% to 8% per annum and constitute over 50% of total volumes. The process of consolidating the brand portfolio around GDBs comes with massive synergies in areas such as advertising, supply chain and complexity reduction in manufacturing. The implementation of enterprise resource planning system SAP has resulted in additional cost savings, leading to annual margin expansions and consequent mid-high single digit operating profit growth.

EXCELLENT CASH GENERATION AND CAPITAL ALLOCATION

BAT has low capital intensity which, when coupled with high margins, results in good free cash flow conversion. This free cash has been used to reward shareholders with high payout ratios coupled with periodical share buybacks. Significant acquisitions have been largely of businesses in which BAT already had a stake, which reduces the associated risk considerably.

REYNOLDS OPPORTUNITY

BAT acquired 58% of the stake it did not already own in Reynolds American Incorporated (RAI) last year. RAI is the second-largest tobacco company in the US with a 35% share of the market, behind market leader Altria, which owns the popular Marlboro brand. This deal makes BAT the largest tobacco company in the world. We believe this is a company-transforming transaction for BAT, providing it with access to the third-biggest, most profitable and one of the most affordable tobacco markets in the world. RAI has much room to increase prices without making cigarettes in the US too expensive. There are also significant cost and revenue synergies from combining the two businesses, and it gives the kind of scale required to invest in NGPs.

NGP OPPORTUNITY HAS POTENTIAL TO STEP CHANGE EARNINGS BASE

BAT has made significant investments into NGPs, a term used to describe various smoking devices that seek to deliver nicotine and other flavours in ways that are safer than combustible cigarettes. These can be grouped as heat-not-burn and e-vapour products; the key difference is that the former heats up actual tobacco while the latter heats up liquid/salts. The NGP category is growing rapidly across the world (forecast to be a £30 billion market by 2020). The US has the largest e-vapour market and Japan the largest heat-not-burn market. Due to a combination of premium positioning and favourable tax treatment, these products are two to three times more profitable than normal cigarettes. BAT is currently rolling them out aggressively across 14 countries. We believe these products could add at least 15% to BAT's earnings base over the next five years.

> BAT has the ability to pass through pricing ahead of inflation significantly more than the average company.

FOOD AND DRUG ADMINISTRATION (FDA) CONCERNS

BAT's share price has come under a lot of pressure in recent months, more so than its competitors. Besides rising global bond yields which have put pressure on most global staples, BAT is facing an uncertain regulatory environment in the US, its largest market. However, given improvements in NGP technology, there is now an alternative to smoking for those who still want nicotine.

The US FDA is starting a comprehensive process that seeks to develop a product standard for combustible cigarettes. Its aim is to reduce nicotine levels in combustible cigarettes to a minimally addictive/non-addictive level. This has the market worried. However, our research suggests that the science supporting any level of nicotine as non-addictive is still very weak at best. In addition, economic effects such as the impact on various state tax revenues and the possible growth of illicit markets will still need to be determined over the next few years. Compared to other markets, US tobacco nicotine content levels are an outlier and could be reduced considerably without affecting the market significantly if effected in a phased approach.

The FDA is also considering regulating flavours in smoking products, including menthol in cigarettes. The intention is to investigate whether certain flavours make it more likely for youth to start the habit of smoking. Menthol cigarettes make up a quarter of BAT's revenue; any ban would therefore be extremely negative. However, the tobacco industry has been down this road before in the US, where a ban on menthol was considered through a process that began in 2011. The attempt was unsuccessful, and there have been no significant scientific developments since then that lead us to believe that a different outcome is likely.

CONCLUSION

BAT has delivered considerable value for its shareholders over a long period, despite operating in a closely regulated industry. The tobacco industry has very attractive fundamentals, including pricing power, margin expansion opportunity, strong free cash flow conversion and high returns on investment. With its attractive profitability and positioning, the NGP opportunity has the potential to step change BAT's earnings base. The current uncertainty over potential changes in the US regulatory environment, led by the FDA, has been priced into the current BAT share price. We believe exceptional global staples (for example, Unilever and Nestlé) should be valued at 20 to 22 times multiple to normal earnings. Given the regulatory risks that the tobacco industry face, we discount this multiple by 15%, which is why we value BAT at 18 times multiple to its normal earnings. BAT currently trades at 10.4 times multiple to our assessment of normal earnings, which in our view significantly undervalues the business. ✚

Adidas

Earning its stripes

By Graydon Wilson

THE ADIDAS THREE stripes logo is a familiar sight to sports and fashion lovers the world over. While the brand can be traced all the way back to a German shoe factory owned by the Dassler brothers in the 1920s, Adidas was officially created in 1949 by Adolf (Adi) Dassler. (After a falling out, his brother Rudolf formed Puma.) The company has a long, successful history and is now the largest sportswear manufacturer in Europe and the second-largest globally. Popular products include the *Boost* running shoe and the *Copa Mundial* football boot, which is the bestselling football boot of all time. In this article we discuss the global sportswear market and why we believe the investment case for Adidas presents a compelling opportunity for our strategies.

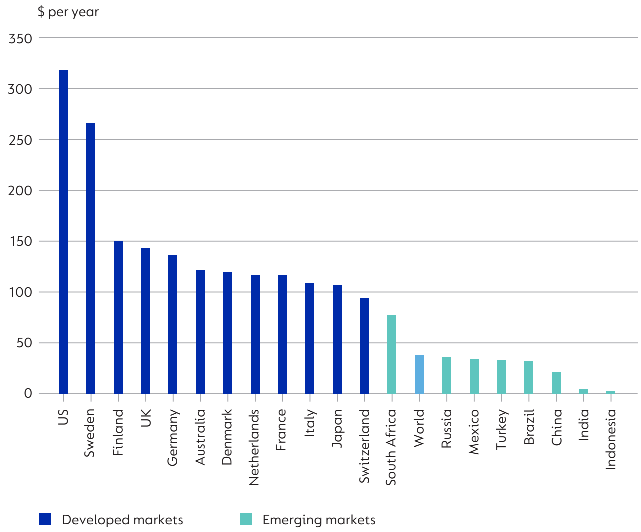
GLOBAL SPORTSWEAR

There are a number of reasons why we consider the global sportswear market to be attractive. It is relatively fragmented, with the largest player, Nike, holding just over 24% market share and Adidas holding around 14%. A fragmented market allows strong brands such as these to gradually increase their share over time, through innovation, superior distribution channels and clever marketing. Customers also tend to be relatively brand loyal, allowing strong brands to enjoy pricing power and healthy gross margins.

Graydon is an analyst within the Global Emerging Markets investment unit. He joined the company in January 2016 and is a qualified chartered accountant.

PER CAPITA SPENDING ON SPORTSWEAR

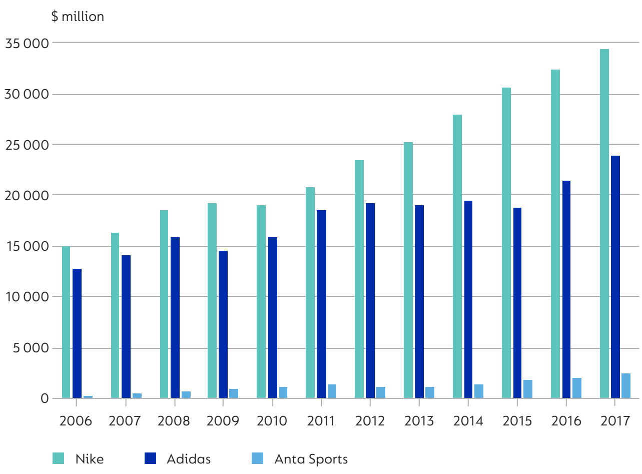
Most upside clearly resides in emerging markets



Sources: Credit Suisse Emerging Consumer Survey, Euromonitor

Sportswear is estimated to be a $350 billion annual industry. The market has grown strongly for many years, having experienced over 7% annual growth since 2009. This is more than double global GDP growth rates over the same period. Despite this impressive performance, there is still a significant runway for growth as emerging market consumers substantially underspend on sportswear relative to their developed market counterparts. Rising emerging market income levels mean growing numbers of middle-class consumers with more discretionary spending and greater participation rates in sports and leisure activities.

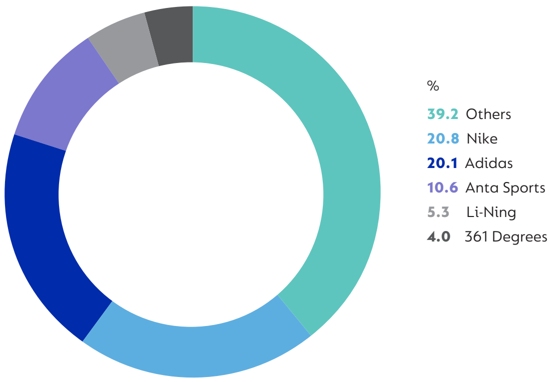
REVENUE COMPARISON OVER TIME



Source: Bloomberg

China is expected to be a significant growth driver going forward, powered by a growing middle class and a new national fitness plan with ambitious targets for fitness levels and increased sports participation. In 2015, the size of the Chinese middle class reached 109 million adults, surpassing the US for the first time. China also has 425 million Millenials who have grown up with social media and put a premium on looking good. A good physique is now associated with virtues such as perseverance and self-discipline. According to the China Business Research Academy, gym membership in China doubled between 2008 and 2016. The number of yoga practitioners has more than doubled over the same period, while running is also gaining popularity. The sportswear market in China has consistently grown at double-digit growth rates over the past five years but is still less than a third of the size of the US sportswear market. Nike, Adidas and local Chinese company Anta Sports have strong positions in the country and stand to benefit from a market that we expect will continue to grow at a healthy pace.

SPORTSWEAR MARKET SHARE IN CHINA



Sources: Euromonitor, Macquarie

Sportswear brands have benefited significantly from ‘athleisure’ trends and the casualisation of work attire over time. Adidas in particular has done very well partnering with global celebrities such as Kanye West and Pharrell Williams, with new limited edition designs that have created much hype for the Adidas brand and positioned its sneakers and clothing as high-quality, aspirational products in the consumer’s mind.

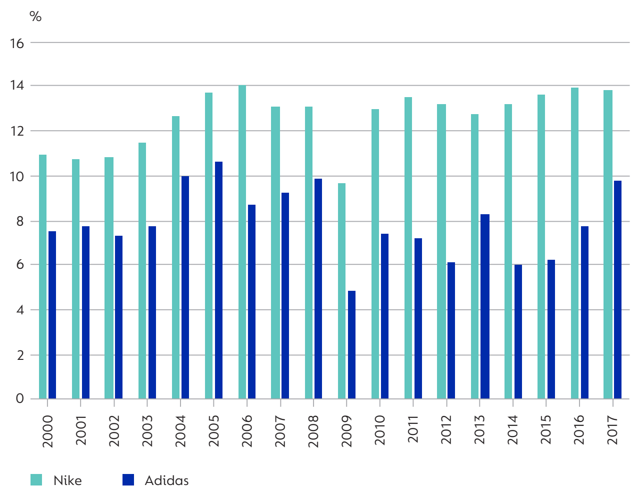
ADIDAS GETS ITS BOOST

Over longer time periods, Nike has outperformed Adidas from a sales growth and margin perspective, to the point where we believe Adidas was underearning relative to its potential. In 2015, a new game plan was announced at Adidas called ‘Creating the New’, which is being driven by a new management team. Current CEO Kasper Rorsted has enviable credentials and from 2008 to 2016 was responsible for the impressive turnaround of another underperforming German business – chemical and consumer goods company Henkel. He did this by focusing the product portfolio and instituting a new entrepreneurial, performance-driven culture at the company. There are early signs of him adding similar value to the Adidas business.

The new game plan is based on three strategic pillars – speed, key cities and open source. First, Adidas is focused on increasing the speed of its supply chain and production processes to be at the cutting edge of new fashion trends and improve the availability of product. Secondly, recognising that this is where new trends develop, the company has directed it sales and marketing activities towards six of the world's most influential metropolitan centres – New York, Los Angeles, London, Paris, Shanghai and Tokyo. Thirdly, 'open source' describes a new drive of inviting athletes, consumers and partners to collaborate with its brands. This has resulted in successful new products sold under the *Adidas YEEZY* and *Adidas Originals* names.

On the back of these initiatives, sales have grown at healthy double digits over the past three years and operating margins have increased from 6% to 10%, which represents a 55% increase in margin. Growth has been broad based, with the company's three major regions (North America, Europe and China) growing significantly. Despite impressive recent financial performance, we believe there are still improvements to come. In spite of steady advances over the last decade when the company set out to narrow the gap between Nike and itself, operating margins are still significantly below those of its main rival (see the graph below) and management is focused on further expanding margins over the foreseeable future. This will be driven by a number of factors, including increasing the share of direct-to-consumer sales, which consist of physical Adidas store sales and ecommerce. Sales through these channels result in higher gross margins as they capture the retail markup in addition to the wholesale margin they would otherwise have earned.

OPERATING MARGINS



Source: Bloomberg

As a key strategic focus area for management, ecommerce is expected to grow strongly going forward, and will allow Adidas to gain the above-mentioned retail markup with less of the associated cost that goes with running physical retail infrastructure. Other initiatives to improve margins include driving more full-price sales with the company's 'speed' initiatives, and further cost-saving projects. Adidas also owns the less significant and underperforming Reebok brand, which we believe the management team will turn around over time.

CONCLUSION

Our investment team has closely followed both Adidas and Nike for a number of years. Due to similarly compelling investment cases, we have owned both companies at varying sizes in our strategies over time. We also like the fundamentals of Anta Sports, a homegrown Chinese sportswear company that we have analysed in detail in the past but have chosen not to own due to a high valuation and an insufficient margin of safety. All three stocks have done well over the past five years, beating the broader market comfortably.

Adidas is a world-class premium sports brand, with strong market positions in attractive, growing categories and across geographies. We are encouraged by the fact that the business now has a strong management team with a good track record that is doing the right things to improve the operational performance of the company.

After reducing its debt levels over recent years, the company also has a strong balance sheet and is committed to returning excess capital in the form of dividends and share buybacks. A recent pullback in the share price in late 2017 meant that the stock was trading on 20 times earnings, at a material valuation discount to Nike and with a better earnings growth profile due to its low margins. This provided us with an opportunity to build a meaningful position in our strategies. ✚

Ho Chi Minh City vs. Cairo

What you see is not always what you get

By Peter Leger

INVESTING IN FRONTIER markets provides for a huge cross section in opportunities as market dynamics differ significantly. From the currency-frozen markets of Zimbabwe to the mature markets of Eastern Europe, there is something for everyone. Of course, the key to making returns in these markets is all about what you pay.

As far as frontier markets go, Vietnam is a pleasure to visit. The visa process is a breeze and as you land there is a steamed bunfight of hawkers trying to sell you cheap mobile cards, currency and transfers – pretty much whatever you might need and more. Everything works, without having to pay excessively for it. Hotels are superb, the food quality is incredible and for less than a dollar you can jump on the back of an Uber scooter and zip through the craziness to whatever awaits.

We visited Vietnam in March to meet with a number of companies. It is an economy on the rise, growing at 7% per annum and with much going for it. It is a decent-sized market with close to 100

Peter is head of Global Frontiers and manages all strategies within the global frontiers offering. He joined Coronation in 2005 and has 20 years' experience in the financial markets in Africa as both a portfolio manager and research analyst.

million people with a wonderful work ethic and a 'can-do' attitude. Still, in the Coronation Global Frontiers strategy, we have zero exposure to Vietnam.

WHAT GIVES?

The current optimism towards Vietnam has seen very large capital flows into the country. It is a market with a healthy 18% of MSCI Frontiers Index weighting and managers of both Frontier and Global Emerging Market assets have been enthusiastic supporters.

However, the Vietnamese stock exchange is quirky. Trades have to be prefunded. A number of companies have foreign owner limits, which means stocks trade at two price points – one level between domestic buyers and another, much higher level, between foreign buyers. The foreign transactions are opaque and the regular market bid-offer transparency is not there.

A large number of listings have recently come to market, to great support. We have battled to find value and have resisted the temptation to buy into the momentum. An extreme example of the value dislocation is the coming to market of the largest cable operator, VTV: a 48% stake is being offered at 260 times 2016 earnings and 20 times its book value. As yet, there are no 2017 numbers available. The fact that something like this can even be brought to market screams warning signs.

So we left Ho Chi Minh city empty-handed following our trip. The story is great. The opportunity set is far less so.

SO WHERE DO WE SEE VALUE?

An interesting exercise is to compare Vietnam to Egypt. Both countries have populations close to 100 million people and their respective GDPs per capita are almost identical, at \$2 482 and \$2 492 respectively for Vietnam and Egypt. While it is treacherous to use read-across metrics such as market capitalisation to GDP, it is interesting that the Vietnamese total market capitalisation weighs in at \$154 billion while that of Egypt is only \$42 billion. Ratings in Vietnam are far higher, at an average of 21 times earnings, with the more interesting stocks trading at further premiums of as much as 50% due to foreign ownership levels. We would argue that the earnings base is also much higher in Vietnam, given the more stable multiyear growth history. Egypt trades on an average multiple of 15 times earnings, with the earnings base below normal given the country's recent history.

This quarter, we met with a number of Egyptian companies. We are still managing to find high-quality businesses on single multiples – and this in an economy where inflation and interest rates have recently spiked and are now coming down quickly. Interest rates were cut 200 basis points this quarter, with expectations of further cuts in the months ahead. Inflation is likely to hit single-digit figures this year from having hit 30% in 2017.

Most of the businesses we talked to spoke of an improving trading environment. Economic reforms of the last couple of years are starting to yield results and the outlook for Egypt to experience growth over the next few years is good. However, due to previous hard years, many of these businesses have earnings well below our estimate of normal. So despite the strong stock market performance in Egypt, there are still companies trading below their intrinsic value.

While we hold no Vietnamese exposure today, we hold maximum positions in Egypt in both our Africa Frontiers strategy and our Global Frontiers strategy. This is as a direct result of specific high-conviction stock positions that stack up to give the overall exposure weighting.

I remember a conversation with a potential investor who was looking at Africa in 2014, when the markets had run hard. He said, "Give me a call when things are on single earnings multiples". After the torrid 2015 and 2016, I did just that and gave him a call. "Oh no, I can't invest in Africa! There's just so much bad news," he said. And that is the thing – most investors want the kind of deal that the UK is looking for in Brexit – divorce where you get to keep all the brilliant children, and pass on the delinquents. High-growth markets and single-digit multiples seldom go together. We think we might have found one in Egypt. ✚

Rising global inflation

How worried should investors be?

By Tony Gibson

AFTER AN UNPRECEDENTED 16 months of consecutive gains, it was not surprising that global equities experienced a sharp rise in volatility at the end of the first quarter of 2018. Initially, there was a sharp sell-off in February. While the monthly decline in US equities was 4.2% in February, the fall approached 10% at one point during the month. The MSCI Emerging Markets Index fared even worse, with a decline of 4.6%.

Tony is a founder member of Coronation and a former CIO. He established Coronation's international business in the mid-1990s, and has managed the Global Equity Fund of Funds strategy since inception.

TURBULENCE IN THE EQUITY MARKET

These falls were essentially due to an equity bull market that has risen for a very long time without any material correction. The trigger for the sell-off was most likely concern about rising inflation and bond yields, with the 10-year US Treasury yield having risen from 2.41% at the end of last year to a high of 2.95% by mid-February. Commodity prices fell along with other risk assets, with Brent Crude and natural gas down by 6% and 7% respectively during February. However, the heightened volatility during late March and early April was due to a more specific event – the escalation in retaliatory exchanges between Washington and Beijing regarding terms of trade. This elevated concerns of a nascent 'trade war'.

Although a little technical, another factor needs to be highlighted. Against this fundamental backdrop, a 'volatility event' related to the rapid liquidation of short-volatility positions in inverse Volatility Index (VIX) products appears to have exacerbated turbulence in the equity market. This was reflected in a 116% increase in the Chicago Board Options Exchange (CBOE) VIX on 5 February, which was its largest ever one-day change.

This event was not unlike the 'flash crash' of May 2010, given that equity volatility spiked far more dramatically than the volatility of rates, currencies or oil prices. A study of the 2010 event by the US Securities and Exchange Commission observed that "the interaction between automated execution programs and algorithmic trading strategies can quickly erode liquidity and result in disorderly markets".

We believe that volatility of this magnitude, rather than being an outlying event, might well be the new normal. During this period, there was no protection to be found in bonds or gold, while equity sector diversification did not help either. All assets correlated.

The massive inflow into passive management has played a big role in creating this new environment. It is estimated that the exchange-traded fund (ETF) industry's assets under management stood at $4.6 trillion at the end of 2017. In 2017 alone, ETF assets grew by over one trillion dollars compared to the US mutual fund industry that recorded growth of a mere $91 billion. Passive capital inflows therefore outgrew active flows by a factor of 10. During the first week of February, ETF outflows were $30 billion, which was sufficient to cause significant market disruption. This of course begs the question as to what would happen if these outflows were far larger; an outflow of, say, $300 billion will be a small percentage of recent flows into ETFs, yet the impact on volatility and correlations will most likely be extreme.

The correction in February left the MSCI World and MSCI Emerging Markets indices trading at reasonable levels of 16.0 and 12.4 times estimated earnings, which suggests that valuations alone are not an impediment to the resumption of the global equity bull market in coming quarters.

However, ETF outflows aside, even modestly rising inflation pressures and further gradual movements toward interest rate normalisation among major developed market central banks suggest a continued move towards more normal levels of equity market volatility, certainly relative to the extremely passive conditions of 2017.

Meanwhile, investors will continue to watch key risks closely. These include US inflation and interest rate pressures, the possibility of a significant slowdown in China in response to the negative credit push, rising trade tensions as the Trump administration seeks leverage in trying to renegotiate trade tariffs and the ever-present 'tail risk' of rising geopolitical risk associated with the nuclear standoff between the US and North Korea.

GLOBAL GROWTH OUTLOOK BUOYED BY CURRENT MOMENTUM

Notwithstanding recent concerns and increased volatility, we believe that the bull case for equities will endure for a while yet. The synchronised global expansion seems set to continue for several years, inflation remains moderate on a global basis, central banks are still providing ample liquidity and equities continue to look attractively priced relative to government bonds.

We believe that the fundamental outlook for global growth and interest rates is little changed from where it stood at the start of 2018. Global economic data continue to reflect an impressive, broad-based global economic expansion. Economists estimate that global manufacturing output accelerated to a 5.5% annual rate in the last quarter of 2017, its fastest pace since 2010.

As last year's second-half rise in energy prices begins to dampen consumer spending, the pace of this expansion is expected to ease somewhat this year. However, there is sufficient momentum in the global economy that labour and product market constraints in developed markets should push both wage and core CPI inflation higher in coming quarters, along with expectations about central bank policy rates.

Outside the US, there has been relatively little change in expectations regarding monetary policy among the major central banks. Despite a noticeably stronger Eurozone economy, the European Central Bank is still on an extremely gradual path toward policy normalisation. Quantitative easing is widely expected to end only in September, while the first rate hike is not expected until the first or second quarter of 2019.

In Japan, officials continue to stress that no change in its quantitative easing programme should be expected anytime soon, but economists there believe that the Bank of Japan may ratchet up its target level for 10-year government bond yields from the current level of zero to 0.25% by the end of the year. In both Canada and the UK, interest rate futures markets predict the most likely scenario for further rate hikes coming at each central bank's May meeting.

Taking a longer-term perspective, although we are late in the economic cycle, ongoing cyclical tail winds should fuel economic resilience in the US over the next 24 to 36 months. A key driver of this surprising resilience is the growth created by the coming of age of American Millennials, overlapping peak spending by Generation X families and the ageing but still healthy Baby Boom young seniors.

Collectively, the maturing of the core of a large generation exaggerates consumer demand, workforce productivity, capital investment and economic growth. Housing is an important component of this. In the US, estimates are that 400 000 housing units are lost each year, for example through demolitions and fires.

To keep pace with the net rise in American household formations, at least 1.5 million new units must be built each year over the next decade. While the number of housing starts has rebounded slightly over the past three years (after the post-2008 supply glut absorbed from 2010 to 2014), building is still far below what is needed to meet rising Millennial Generation demand. Supply shortages have fed housing price inflation and set the stage for a further rise in residential construction across the country.

Additionally, following the 2008 financial crisis and global recession, many analysts had forecast that annual US new vehicle demand would never rebound above 16 million units. This belief >

was built on the understanding that the pre-crisis numbers were inflated by subprime lending, high fleet sales and irresponsibly low lease-end residuals. Yet demand has rebounded to a cyclical high above 17 million units per year. Although sales may soften slightly this year to about 16.8 million units, the consistently strong numbers are due to lower income taxes, rising household incomes and full-time employment and wages for Millennials, the largest market for new vehicles over the next 12 years.

INVESTOR CONCERNS ABOUT INFLATION ON THE RISE

As alluded to earlier, for the first time in many years, investors are becoming increasingly concerned about potential inflation, particularly in the US. This concern is based on the acceleration in the US hourly earnings to a 2.9% year-on-year pace in January, while the CPI rate also jumped by a greater than expected 0.5%.

Additional concerns arise from the fact that, on a forward-looking basis, US fiscal policy is becoming highly expansionary at a time when the economy is already at full employment. Based on the combined effect of previously announced tax cuts and a US budget deal in February that increases government spending by almost $400 billion, estimates are that 0.7% will be added to GDP growth in 2018 and 0.6% in 2019.

This has raised concerns that the US Federal Reserve (Fed) will need to push up interest rates more than was expected earlier. Interest rate futures are now pricing in a 35% chance that the Fed will hike rates four or more times by the end of this year, even though three rate hikes remain the most likely scenario.

Taking a longer-term outlook on inflation, in our opinion demand-pull inflation is no longer a force in the industrialised northern hemisphere, with the exception of the US. Essentially, this is due to the secular ageing and imminent contraction in the populations of Western Europe, Eastern Europe, Russia, Japan and South Korea. China will soon follow along this path, as its working-age population has already begun to shrink.

Since the US population is still growing, albeit slowly, brief surges of demand-pull inflation are still possible. However, ongoing contraction of consumer demand across most of Europe and North Asia will mute or offset such cyclical pricing power over the next few decades. While currency weakness or supply disruptions will cause periodic short-term local or regional inflationary pressures, any such pricing power will be short-lived due to the slow but inevitable deterioration of demand in the industrialised north.

Over the next decade, resilient US demand and rising per capita consumption in emerging South Asia are likely to offset demand weakness in Europe and Northeast Asia. However, the collective global shrinkage of demand will become more pronounced over the next 10 years as population ageing and contraction outside the US gathers momentum. Therefore, while investors must focus near term on modest pricing pressures created by the US- and China-led synchronised rise in global growth, any inflationary pressure is likely to be muted and short lived.

While manipulation of monetary and fiscal policies may temporarily boost input and consumer prices, over the longer term fewer high-income consumers will lead to reduced demand for food, energy, materials, goods and services. Meanwhile, year-on-year consumer inflation is moderating or under control in the world's three largest emerging economies.

Put another way, if the populations of Europe and Northeast Asia were growing at a rate similar to the US, it can be argued that there would not have been a decade-long distortion of extremely low interest rates. As is well known, some of the consequences of these policies are blown-out equity price-earnings ratios, as well as impacts on asset allocations, commodity demand and over-leveraging in a reach for real yields. To give this perspective, we know that an individual consumes more at age 40 than at 60. The ageing of Europe and Japan has thus had a significant negative impact on collective global demand, and in turn, on pricing power for materials, goods and services.

> Notwithstanding recent concerns and increased volatility, we believe that the bull case for equities will endure for a while yet.

Looking forward, the drag will become even more pronounced as most countries in the industrial north see their populations age further and decline in number. Fewer and older is a recipe for decline in demand, economic growth and public sentiment, and as a consequence, potentially political stability. While inflationary pressures will most likely see a late-cycle lift over the next 18 to 24 months, this pricing power is likely to prove temporary as secular deflationary pressures take hold during and beyond 2020.

Therefore, while fears of deflation and recession are currently giving way to worries about overheating due to recent ill-timed fiscal stimuli, it may not be long before investor concerns begin to turn back toward fears of stagnation and the social pressures associated with stagflation.

POSITIVE US ECONOMIC DYNAMICS REMAIN

In summary, fears of a near-term US recession should fade as we move into the second quarter, as the stimulus created by tax cuts, federal spending hikes and modestly higher wages boost consumer spending and capital investment. This is of course based on the view that it is in neither the US nor China's interest to allow a full-scale trade war to take hold. However, this late-cycle growth is likely to dissipate later next year and into 2020 as rising interest rates dampen public and consumer spending and cause renewed job market anxiety. That said, while momentum investors will expect this slowdown to become irreversible, the positive dynamics of virtuous US population demographics should surprise the pessimists and reward long-term investors with a resumption of strong economic growth from the US. This will widen the divergence between North America and the ageing and contracting populations of Europe, Japan, Russia, South Korea and most of China. ✚

FACTFILE

Coronation Africa Frontiers strategy

INCEPTION DATE

1 October 2008

BASE CURRENCY

US$

PORTFOLIO MANAGER

Peter Leger is the head of Coronation's Global Frontiers investment unit and has been managing all Global Frontiers portfolios since inception. He joined Coronation in 2005 and has 20 years' experience in African financial markets as both a portfolio manager and research analyst.

OVERVIEW

In October this year, we will celebrate the 10th anniversary of our Coronation Africa Frontiers strategy. Over the years, we have repeatedly made the case for a direct allocation to frontier markets, as they are under-represented in major global indices and under-researched by the world's investors. The Africa Frontiers strategy leverages off our multidecade experience in managing money in an emerging market like South Africa.

The Coronation Africa Frontiers strategy aims to maximise the long-term, risk-adjusted returns available from investments on the African continent through capital growth of the underlying stocks selected. It is a flexible portfolio, primarily invested in listed African equities or stocks listed on developed and emerging market exchanges where a substantial part of their earnings are derived from the African continent. The strategy may hold cash and interest-bearing assets where we find this appropriate.

STRATEGY

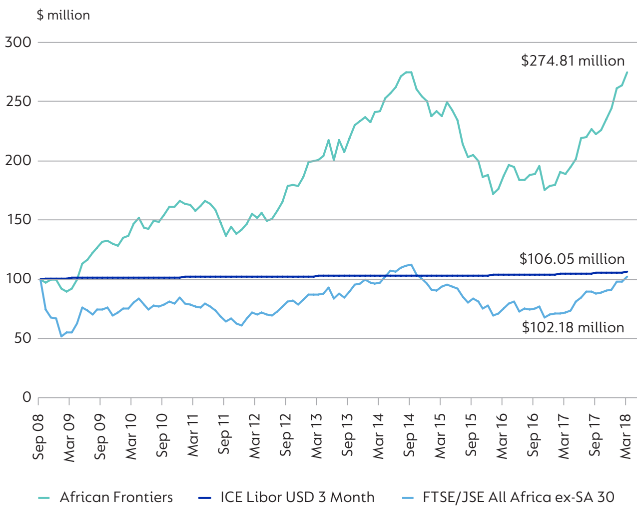
Coronation Africa Frontiers follows a long-term, valuation-driven investment philosophy. We emphasise bottom-up stock selection >

COUNTRY ALLOCATION (AS AT 31 MARCH 2018)

Country	% strategy
Egypt	35.7%
Nigeria	18.5%
Kenya	14.3%
Zimbabwe	14.1%
South Africa	4.3%
Tanzania	2.5%
Botswana	1.7%
Senegal	1.0%
Zambia	0.9%
Uganda	0.6%
Ghana	0.3%
UK	0.1%
Interest bearing	6.0%

Source: Coronation

GROWTH OF $100 MILLION INVESTMENT



The above graph is provided for illustrative purposes only. It reflects composite peformance of the strategy and is gross of fees. For a side-by-side comparison of gross versus net fees, please visit www.coronation.com/us/strategy-information/strategy-performance/#js-global-strategy

Source: Coronation

rather than top-down geographic allocation or macro themes, an approach that has been applied across all our strategies for more than two decades.

The portfolio holds shares which we believe offer the most attractive risk-adjusted fair value relative to current market prices. Given the lack of reliable information in many frontier markets, calculating what we believe to be fair value of a business requires intensive on-the-ground research, constant contact with management teams and detailed financial modelling that focuses on through-the-cycle normalised earnings and free cash flows over the long term.

Given that shares often trade on near-term earnings prospects instead of their long-term earnings power, we aim to cut out the 'short-term noise' by focusing exclusively on the long term. We believe that our ability to invest with a time horizon of five years and longer is a key competitive advantage, allowing us to invest in assets that, in our view, are trading at substantial discounts to our assessment of their underlying value.

STRATEGY RETURNS GROSS OF FEES (AS AT 31 MARCH 2018)

Period	Strategy	Libor	Active return
Since inception cumulative	174.8%	6.1%	168.7%
Since inception per annum	11.2%	0.6%	10.6%
Latest 5 years per annum	6.5%	0.7%	5.8%
Latest 1 year	45.6%	1.5%	44.1%
Year to date	12.2%	0.5%	11.7%
Month	4.2%	0.2%	4.0%

* For a side-by-side comparison of gross and net performance, please refer to www.coronation.com/us/strategy-performance.

Source: Coronation

The portfolio is constructed on a clean slate basis based on the relative risk-adjusted upside to fair value of each underlying security. It is constructed with no reference to a benchmark, as we do not equate risk with tracking error or divergence from a benchmark, but rather with a permanent loss of capital.

PERFORMANCE

The Coronation Africa Frontiers strategy has delivered compelling performance over all meaningful time periods since inception.

After a strong performance in 2017, markets across Africa continued to rise in the first quarter of 2018. The Coronation Africa Frontiers strategy returned a gross performance of 12.2%, well ahead of its target (outperformance of the 3 Month ICE Libor USD) as well as the FTSE/JSE All Africa ex-South Africa 30 Index, which was up 11.9%.

The large African economies went from strength to strength, shrugging off the increased volatility of developed markets over the quarter. Egypt was up 15.1%, Kenya up 13.7%, Nigeria up 9.5% and Morocco up 7.4%. Zimbabwe was down 10.1%; however, this decline in equity prices was due in part to an improved economic outlook and increased trust in the monetary system.

Equities are no longer deemed a necessary safe haven and cash holdings have increased in the hope of currency normalisation following the November 2017 regime change.

Eastern Tobacco, Stanbic IBTC and Seplat Petroleum contributed a combined 6.1% to the strategy's performance. Eastern Tobacco benefited from improvements in its corporate governance, the share's inclusion in the MSCI Emerging Markets and the FTSE indices and speculation that the company would pay out its excess cash reserves through an interim dividend. There were no meaningful detractors to performance, with no single position detracting more than 25 basis points (bps).

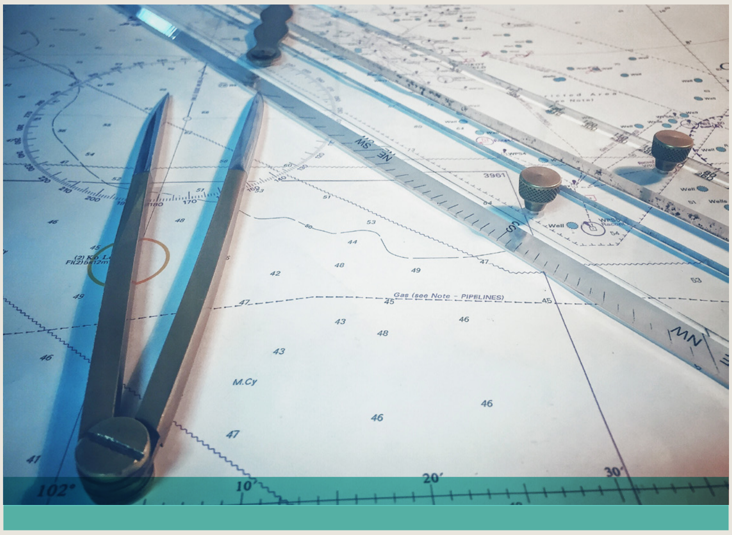
OUTLOOK

We are positive about the prospects of our various investments and remain fully invested in Egypt (see page 18 for more on this market). We met with a number of Egyptian corporates in Cairo, Cape Town and Dubai this quarter and most spoke of an improving trading environment. Headline inflation normalised down to 13.3% in March from the 33.0% peak in July 2017. Interest rates were cut by 200 bps this quarter and most economists expect further cuts in the coming months.

The economic reforms implemented over the past two years are already yielding positive results. As inflation and interest rates continue to decline, we have expectations for Egypt to experience a multiyear period of growth. Given the hardships of the past few years, it is not surprising that many of the companies we meet have earnings well below our estimate of normal. Despite the strong stock market performance, we thus continue to find companies that are trading below their intrinsic value.

We increased the Africa Frontiers strategy's exposure to Qatar National Bank Alahli (QNBA) significantly this quarter. QNBA is the largest private sector bank by loans and second largest by deposits in Egypt. Over the longer term, the Egyptian banking sector is incredibly attractive and QNBA is well positioned to benefit from Egypt's improved business confidence.

We are excited by the holdings in Egypt and across the Coronation Africa Frontiers strategy; however, we always remain cautious when years start out as strong as 2018. While pleased with performance year to date, we are mindful that markets are volatile and seldom increase in a straight line. Despite any near-term volatility, we continue to believe that long-term returns will be attractive for the valuation-focused, bottom-up investor. ✚



International portfolio update

CORONATION GLOBAL EQUITY FUND OF FUNDS

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Jul 00	16.30%	8.47%	10.64%	6.79%
Benchmark		14.85%	8.61%	10.33%	4.80%

Annualised, quoted in USD
Sources: Coronation, Bloomberg

The fund declined 0.1% against the benchmark return of -1.0%, bringing its rolling 12-month performance to 16.3% against the 14.9% returned by the MSCI All Country World Index (ACWI).

Japan was the best-performing region, rising 1.0% (in US dollar terms) over the quarter. The weakest return was from Pacific ex-Japan, which declined 3.7% (in US dollar terms). Europe also fell by 1.9% (in US dollar terms) and North America was 1.0% weaker. Emerging markets advanced 1.1% (in US dollar terms), outperforming developed markets. On a look-through basis, the fund is overweight North America and emerging markets and underweight Japan, while its weighting in Europe is in line with the benchmark.

Among the global sectors, information technology (+3.2%) and consumer discretionary (+1.5%) generated the best returns. The worst-performing sectors were telecommunications (-6.4%), energy (-6.1%) and consumer staples (-5.7%). On a look-through basis, the fund benefited from its overweight position in information technology and consumer discretionary, and its underweight position in utilities and telecommunications. Its overweight positions in consumer staples and materials detracted from performance.

The fund's relative outperformance over the quarter was largely a result of good performance across the portfolio. Two standout performers were Egerton Capital and Tremblant Capital.

Egerton Capital returned 2.9% on strong performances from Airbus (+13%) as its order book rose strongly, Adobe (+23%) after its ongoing move to the Cloud gave rise to a strong earnings announcement and Adidas (+18%) following the release of a good set of results and a large share buyback. An overweight position in information technology also boosted returns.

Tremblant Capital returned 2.2%. Its large exposure to consumer discretionary stocks boosted returns even though CBS, one of its top holdings, declined by 13% over the period. Palo Alto Networks (+25%) benefited from the recent US tax cuts as well as improved earnings, while FinecoBank (+14%) saw strong deposit inflows and margin improvement.

Maverick Capital, which has had a tough time in recent quarters, delivered strong alpha this past quarter. Its sizeable exposure to healthcare has been the most significant driver of underperformance over the 12-month period, especially its holding in Shire Pharmaceutical. After large losses in Shire, Maverick Capital re-examined the investment thesis, decided it remained intact and maintained its position. This was rewarded in March when Takeda Pharmaceutical Company announced its intention to bid for Shire and the share price of Shire rose strongly. The manager also benefited from Envision Healthcare (+11%) and Adobe (+23%).

Contrarius Global Equity also had a good quarter. Like Tremblant, it benefited from a meaningful exposure to the consumer discretionary sector, especially the bricks-and-mortar stores such as Macy's (+20%), Dine Brands (+30%) and Abercrombie & Fitch (+40%), which rebounded sharply. Twitter, a long-held position which has disappointed since its listing, also rose strongly after reporting a robust set of financial results.

CORONATION GLOBAL EQUITY STRATEGY

	Launch date	1 year	3 years	5 years	Since inception
Strategy	14 Nov 14	8.43%	6.14%	-	6.01%
Benchmark		14.85%	8.12%	-	7.72%

Annualised, quoted in USD
Sources: Coronation, Bloomberg

The strategy had a disappointing start to the year, underperforming its benchmark by nearly 5% over the quarter. This has affected the strategy's longer-term numbers.

The strategy's biggest positive contributors included Amazon (continued rerating on the back of sound execution and speculation about entering other categories), Advance Auto Parts (turnaround strategy gaining early traction after an oversold share price), Hammerson (an unexpected bid for the company being rebuffed by the board) and Airbus (a recent portfolio introduction continuing to execute well). The largest detractor was the prior quarter's top performer, L Brands, which saw a poor trading statement result in its share price retreating to previous lows. Other losers included Altice NV (a cable operator with poor results in its home market, France), Tata Motors (a victim of market volatility and poor short-term sales numbers) and Intu Properties (amid fears that the proposed Hammerson deal would fall through). Some of the strategy's consumer staple holdings were also marked down in line with the comments above.

We have significantly increased the portfolio's exposure to tobacco stocks over the last 12 months. Currently close to 10% of the strategy is invested in stocks such as British American Tobacco (as featured on page 12), Philip Morris International, Japan Tobacco and Imperial Brands. While each company potentially offers a slightly different angle in terms of future returns, the overarching investment thesis is that the development of next generation products – while disruptive to the incumbent players in what has been a very stable industry – could prove to present the market with a new growth vector. Heat-not-burn and vapour products have found favour with both existing smokers and ex-smokers, and allow the industry to benefit from premium pricing.

The recently announced US Food and Drug Administration review of the industry in America has increased uncertainty in the shorter term, allowing us to pay what we would consider to be attractive prices for these stocks. In the longer run, we anticipate the larger players to consolidate new technologies, leading to improving margins compared to the combustible market (assuming no adverse tax developments). Some of these companies are now trading at valuation multiples not far off those levels when they were facing potentially crippling financial legal claims, and we think these positions will serve the strategy well over the medium to longer term.

While the strategy's short-term performance has been a disappointment, we take encouragement from the fact that the portfolio is showing very attractive potential upside based on our assessment of fair value for our individual holdings.

CORONATION GLOBAL MANAGED STRATEGY

	Launch date	1 year	3 years	5 years	Since inception
Strategy	1 Nov 09	6.58%	5.17%	6.99%	8.64%
Benchmark		11.71%	6.61%	6.68%	7.09%

Annualised, quoted in USD
Sources: Coronation, Bloomberg

The strategy had a disappointing start to the year, underperforming its quantitative benchmark by more than 3.5% for the quarter. Over the longer time periods and since inception, the strategy return is still comfortably ahead of its benchmark.

Our decision to reduce the strategy's equity exposure some time ago added to relative performance, but our stock selection underperformed the ACWI benchmark materially over the quarter >

as well as over the last 12 months. Our instrument selection in property was also poor, as was our overweight position in the asset class. Our credit positions in fixed income performed well, and our gold holding added marginally. Over the last 12 months our biggest detractors were our underweight position in equity and our stock selection within the equity bucket.

Our biggest positive equity contributors included Amazon, Advance Auto Parts, Hammerson and Airbus. The largest equity detractor was the prior quarter's top performer, L Brands. Other losers included Altice, Tata Motors and Intu Properties. Some of our consumer staple holdings were also marked down in line with the comments above. (For more detail on the fund's equity holdings, refer to the Coronation Global Equity strategy on page 27.)

While the strategy's short-term performance has been a disappointment, we take encouragement from the fact that the portfolio is showing very attractive potential upside based on our assessment of fair value for our individual holdings in the equity and property buckets. We continue to manage overall portfolio risk, and again over the last quarter we paid around 25 basis points (bps) away in the form of portfolio insurance. The cost of protection has now risen materially, and we would in all likelihood not replace the current protection measures when they expire.

CORONATION GLOBAL EMERGING MARKETS EQUITY STRATEGY

	Launch date	1 year	3 years	5 years	Since inception
Strategy	14 Jul 08	24.63%	8.47%	5.63%	8.12%
Benchmark		24.93%	8.90%	5.19%	3.88%

Annualised, quoted in USD
Sources: Coronation, Bloomberg

The strategy returned -2.4% for the first quarter of 2018, 3.8% behind its benchmark in what has been a challenging start to the year and indeed other shorter-term periods. Over meaningful periods, the strategy remains ahead of its benchmark, delivering outperformance of 0.4% per annum over the five-year period, 2.9% per annum over seven years and 4.2% per annum since inception almost a decade ago.

The biggest positive contributors for the quarter all came from positions that added positively rather than underweight positions in stocks that performed poorly. The biggest positive contributor was Airbus, up 16% for the quarter and contributing +0.52%. We continue to believe that Airbus is very attractively valued, with 45% upside to fair value, and as such it remains a large position, at 4% of strategy. The second-largest positive contributor was global sportswear group Adidas (c. 55% of revenue from emerging markets), which was bought back into the strategy earlier in the year after we sold it in 2015. Since the date of reintroducing Adidas to the strategy up until quarter-end, the share price gained 22%, contributing +0.50% to alpha. As at end-March, it represented a 3% position in the strategy. Other notable positive contributors were the top Chinese online classifieds company, 58.com (+11% return, +0.35% attribution) and Russia's leading bank, Sberbank (+10% return, +0.24% attribution).

Adidas was the largest new buy this quarter. We had previously owned only Nike, Adidas's perennial industry rival. At the time of purchasing Nike in late 2016, the share was unloved by investors due to concerns over its perceived dependence on the US market and the basketball category in general. At the same time, Adidas could do no wrong as product innovations and other general operational improvements led to market share gains in the US and a substantial improvement in brand equity in most operating regions.

Other sportswear groups also seemed to be making headway at Nike's expense in the US, most notably Under Armour Inc., which at one point reached an earnings multiple of more than 40 times. Despite our attraction to the industry, we believed that Nike was substantially undervalued and Adidas looked expensive. Fast forward just over a year and Nike's share price has increased by close to 35%, while Adidas's lagged significantly, having declined by 5% since March 2017 until time of purchase in January 2018.

The lag in Adidas created a buying opportunity, and the stock has performed very well in this short space of time. The purchase was partially funded by a reduction in the Nike position size, which has gone from over 2% of strategy in recent months to just under 1% by end-March. Although both Adidas and Nike may appear optically expensive based on near-term multiples (c. 24 to 25 times forward earnings), we believe they have well above average earnings growth prospects in the years ahead, driven by changing consumer habits toward greater fitness and 'athleisure', while the companies themselves have identified several routes to raising margins. These include improvements in manufacturing (to lower wasted materials) and increased direct-to-consumer sales (where the retail markup is captured in addition to the usual wholesale margin). In addition to this, Adidas's earnings before interest and tax margins at c. 9% to 10% are still well below that of Nike at c. 13% to 14%. (You can read more about the Adidas investment case on page 15.)

Besides Adidas, the only other new buy was a 1% position in KB Financial, the largest financial services group in South Korea. While banking is a relatively poor industry in South Korea in our view (the industry is mature, heavily regulated in favour of the consumer and has low returns on investment), in the case of KB Financial we were attracted to the steps new management has taken and continue to take to improve returns. These include acquisitions in areas that have more attractive prospects (e.g. securities), acceleration of digital investment on the banking side and headcount reductions. Since the appointment of a new CEO (and a full new management team) in late 2014, returns on investment have increased from c. 5% to 10%. Today KB Financial trades on seven times earnings, 0.7 price-to-book, with a 3.5% dividend yield for a company that, in our view, can grow earnings by c. 10% per annum over the next five years.

Over the quarter we continued to reduce the strategy's Chinese internet exposure as share prices rose and as such moved closer to fair value. We reduced the position in 58.com to 3% of strategy – the share was up 11% in the quarter and would have been approaching a 4% position in the absence of any action. We also lowered the strategy's position in Baidu by 0.5% to 2.1%, in

JD.com by 1.5% to 4.1% and sold out of Alibaba (as it reached our estimate of fair value) as well as Altaba (the former Yahoo whose main asset now is its stake in Alibaba). The combined Alibaba/Altaba position was close to 2.5% at the start of the year. Most notably for the quarter, we reduced our Naspers position by close to 3.5% to just under 4% of strategy. This was driven predominantly by concerns over the valuation of Tencent, which is Naspers's single biggest investment. We also sold out of Aspen (given more attractive risk-adjusted opportunities elsewhere) and Yum China (due to valuation).

We increased the strategy's position size in Ping An, China's largest private insurer, by 1.5% to 3.9%, and raised the holding in global tobacco group British American Tobacco from 3.7% to 5.9%, both as a result of share price weakness.

Two stocks made up the bulk of the strategy's underperformance this quarter: Russian retailer Magnit, which declined by 32% during the quarter (-1.41% attribution) and private educational company Kroton, which lost 26% (-1.44% attribution).

We have written extensively about both businesses in recent years and therefore focus here on incremental news as well as why the shares have been so negatively affected recently. Magnit had already been performing poorly relative to its previous high standards in recent quarters, with sales growth declining from mid-20s to single digits. This was mostly driven by space rather than same-store sales growth. The company's recent struggles seem to have eventually led the founder and CEO Sergei Galitsky to give up and leave the business. He had been reducing his position over time to fund his philanthropic work, but eventually came to the view that, from a personal perspective, staying around for a recovery in the business and share price was not worth it. The sale of most of his c. 30% stake to Russian investment bank VTB Capital (that will look to increase its value substantially for a resale) has led to meaningful changes in management and strategy that we believe will be beneficial in the long term.

An example is the company's historical overemphasis on maintaining margins at the expense of reinvesting in the existing store base. This worked fine when the competition was weak and fragmented, but as X5 Retail improved its operations in recent years, the product offering at X5's stores far exceeded Magnit's more basic stores and led to negative traffic at Magnit. We believe that greater reinvestment in the business would have delivered better returns, as fewer customers would have been lost to competitors and the additional sales revenue would have delivered greater absolute profits to Magnit, even if margins were slightly lower. Galitsky's exit also highlighted that the business has been lacking in professional management, with many senior managers being responsible for multiple portfolios. Professionalising the management structure and having distinct control of functions assigned to specialist managers will help improve processes and make the company less dependent on a single individual in future. We were buyers of Magnit over the quarter and at end-March it was a 3.7% position.

> The strength and depth of management at Kroton places it among the best in global emerging markets.

The other big detractor has been Kroton, which has fully given up the gains it achieved since competition authorities blocked its merger with Estácio by the middle of last year. Investor perception toward the private education industry in Brazil has cooled in recent quarters due to a variety of factors. First, intakes have stagnated or declined as affordability has become more of an issue for students. Although the Brazilian economy has exited its deep recession of 2015 and 2016, the recovery has been very shallow, without a substantial improvement in job prospects for the workforce. With most of the students working in the day and studying at night, the poor job market has made affordability quite difficult for new entrants and has even affected the existing student base, which has seen a spike in dropouts after holding up well until recently.

Ordinarily the government student financing scheme would have helped maintain enrolment momentum, but since 2015 this scheme has been halved and made more expensive for those that qualify. The tough market has also put pressure on pricing, with many industry players offering discounts to entice students, leading to lower average fees ('tickets', as they are referred to in Brazil). This has been particularly pronounced in the distance learning segment where government last year substantially lowered barriers to entry. From a high-level viewpoint, the industry is seen as one where near-term revenues will be under pressure, so the only chance of decent profit growth is through margin expansion. As the largest player in the industry and with many government student loan beneficiaries due to graduate this year and the next, the market is pricing Kroton for revenues to decline. As its margins are already the highest in the industry (thanks to economies of scale and excellent management) there is little scope for Kroton to deliver earnings growth if one subscribes to this viewpoint. Kroton has therefore de-rated to 10 times earnings.

While we acknowledge the merit in some of these issues, we believe there are strong counterarguments that make Kroton a very compelling investment, which is why we have been increasing the position into share price weakness. It is important to identify that the longer-term drivers of the industry remain intact: Brazil has an acute skills shortage and the return on investment for students who study certain courses is very high. The industry is fragmented and the profitability of smaller players is minimal – many survive simply because they own the building out of which they operate and therefore do not have to pay rent. Kroton's high market share should therefore not serve as a barrier to continued student growth over long periods of time, as the market will consolidate over time. Kroton's scale and strong brands make its degrees more attractive, which raises long-term pricing power. With its solid balance sheet and high profitability, the company is uniquely positioned within the industry to offer pioneering financing schemes that >

allow students to spread out their payments beyond the duration of their degree, which will make them more affordable to marginal students. This will help offset some of the negative impact of lower government student loans.

During the quarter we met with the CEO, CFO, CTO and various divisional heads of Kroton in Brazil. In our view, the strength and depth of management at the company places it among the best in emerging markets. Kroton long ago identified that pricing would be an issue, and has slowly migrated its intake away from low-ticket courses such as business administration into more technical courses (like nursing, dentistry, education and law) where the average ticket is three to four times higher and the barriers to entry for smaller players to follow are far higher.

The regulatory hurdles that limit the pace at which new courses can be added to existing universities mean this process will take several years to play out, but the end result will be higher student numbers driven by organic growth, higher average tickets as Kroton's course mix shifts toward more expensive courses and higher margins as the company reaps further economies of scale. Kroton is also making a concerted push into the private school market as this industry has great economics too (a student stays with you for 12 years instead of 4) and remains very fragmented despite many strong local brands. At 10 times earnings we believe you are buying the current earnings stream at a substantial discount and getting all of the above optionality for free. Kroton was a 5.0% position at end-March and is the second-largest position in the strategy.

Members of the team continue to travel extensively to enhance our understanding of the businesses we own in the strategy, their competitors and the countries in which they operate. In the quarter the team visited Brazil, India and China, and we will visit Russia, South Korea, Taiwan, Indonesia and Singapore in the coming weeks. The weighted average upside to fair value of the strategy at the end of March was c. 45%.

CORONATION AFRICA FRONTIERS STRATEGY

	Launch date	1 year	3 years	5 years	Since inception
Strategy	1 Oct 08	45.59%	4.92%	6.46%	11.23%
Benchmark		1.51%	0.93%	0.66%	0.62%

Annualised, quoted in USD
Sources: Coronation, Bloomberg

After a strong performance in 2017, markets across Africa continued to rise in the first three months of 2018. Against this backdrop, the strategy's gross return was 12.2%, compared to its target (3 Month USD Libor + 5%) which was up 1.7% and the FTSE/JSE All Africa ex-South Africa 30 Index, which was up 11.9% for the quarter.

While volatility increased in developed markets, the large African economies shrugged off these concerns and went from strength to strength. Over the quarter, Egypt was up 15.1%, Kenya up 13.7%, Nigeria up 9.5% and Morocco up 7.4%. Zimbabwe was down 10.1%; however, this is somewhat misleading as the decline in equity prices was due in part to an improved economic outlook and increased trust in the monetary system. Equities are no longer viewed as a necessary safe haven and cash holdings have increased in the hope of currency normalisation following the November 2017 regime change.

The main contributors to performance over the quarter were Eastern Tobacco, Stanbic IBTC and Seplat Petroleum, which contributed a combined 6.1% to the strategy's performance. Eastern Tobacco benefited from a number of improvements in its corporate governance, the share's inclusion in the MSCI Emerging Markets and the FTSE indices and speculation that the company would pay out its excess cash reserves by way of an interim dividend. An interim dividend was confirmed in early April. There were no meaningful detractors, with no single position detracting more than 25 bps.

We continue to be fully invested in Egypt and we are very excited about the prospects of our various investments. Over the quarter we met with a number of Egyptian corporates in Cairo, Cape Town and Dubai. Most talked to an improving trading environment. Inflation has normalised, with March seeing headline inflation of 13.3%, down from the 33.0% peak in July 2017. The Central Bank cut interest rates by 200 bps during the quarter and most economists expect further cuts in the coming months. The reforms put through over the past two years are already bearing fruit. As inflation and interest rates continue to decline, we would expect Egypt to experience a multiyear period of growth. Given the past few years of hardship, it is unsurprising that many of the companies we meet have earnings well below our estimate of normal. As such, despite the stock market performance, we continue to find companies that are trading below their intrinsic value.

The strategy significantly increased its exposure to Qatar National Bank Alahli (QNBA) over the quarter. QNBA is the largest private sector bank by loans and second-largest by deposits in Egypt. The bank is well positioned to benefit from Egypt's improved business confidence. As interest rates decline, loan volumes should pick up meaningfully. As loans increase, so too should the associated fees and commissions. This will drive a normalisation in non-interest revenue, which is currently at multiyear lows.

Over the longer term, the Egyptian banking sector is incredibly attractive. Credit penetration is very low at c. 35% and retail growth should continue for years to come. Finally, QNBA's parent Qatar National Bank is well funded, with strong international relationships that stand to benefit QNBA. The share trades at half the price-to-book multiple of the more liquid Commercial International Bank (CIB). We do not believe that simply because a company has a larger free float it should trade at twice the price of a less liquid peer. As a result, while we believe that CIB is an attractive investment in its own right, we see QNBA as more attractive from a valuation perspective.

While we remain excited by the holdings in Egypt and across the strategy, we are always sceptical when years start as strongly as 2018 has. We are pleased with performance year to date but remain mindful that markets are volatile and seldom increase in a straight line. We continue to believe that for the valuation-focused, bottom-up investor, returns in the long run will be attractive despite any near-term volatility.

CORONATION GLOBAL FRONTIERS STRATEGY

	Launch date	1 year	3 years	5 years	Since inception
Strategy	1 Dec 14	38.05%	11.17%	-	9.02%
Benchmark		1.51%	0.93%	-	0.86%

Annualised, quoted in USD
Sources: Coronation, Bloomberg

The strategy returned 7.2% (gross) for the quarter, compared to the target (3 Month USD Libor +3.5%) which was up 1.4% and the MSCI Frontier Markets Index, which was up 5.1% over this period. The strong performance was driven by Vietnam (+18.4%), Egypt (+15.1%), Kenya (+13.7%), Nigeria (+9.5%), Morocco (+7.4%) and Kuwait (+5.1%), while Bangladesh (-12.9%) and Argentina (-5.3%) declined.

When selecting investments we use a bottom-up, valuation-driven approach. We are completely benchmark agnostic and our focus is to generate attractive absolute returns for investors in the strategy, rather than to outperform an often poorly constructed benchmark. We avoid overpaying for companies where valuations are not justified, which ensures that we minimise the risk of a permanent loss of capital. A case in point is some of the valuations we currently see in Vietnam.

We visited Vietnam in March where we met with a number of companies. With strong GDP growth and booming exports it is easy to see why investors love the country. The market is incredibly well liked and is widely held in frontier and even emerging market funds. As a result, Vietnam is up 18.4% over the past three months and up 61.5% over the past 12 months. From a bottom-up perspective, however, the market is trickier. Many companies have reached their foreign ownership limits, which means that foreigners have to pay large premiums to buy shares in these companies – sometimes as high as 30%. Your return as an investor will therefore be materially different from the return shown by the quoted share price.

There are a number of quality businesses in Vietnam we would want to own at the right price; however, the optimism is clearly reflected in the valuations of these businesses. A number of banks are trading on price-to-book valuations above three times; for one of the largest banks in the country, Vietcombank, you now have to pay almost five times book value. There are also many consumer-focused businesses trading on high price/earnings multiples, some higher than 30 times earnings. Recently, a stake in Sabeco, the country's largest beer producer, was sold at a multiple of approximately 44 times earnings. The growth that these businesses will have to achieve over the next few years to justify these multiples are simply too ambitious in our view. In our experience, paying a high multiple on earnings that are already at elevated levels is very dangerous.

We believe that the benefits of a valuation-driven approach is demonstrated by the fact that despite owning no companies in Vietnam over the last three months and only a small position over the past year, the strategy still performed better than the MSCI Frontier Markets Index over three months, one year and since its inception in December 2014. The largest contributors to performance over the past quarter were Eastern Tobacco (adding 1.5% to the strategy return) and CFC Stanbic (adding 0.9%). Both are quality companies which we own because they trade well below our assessment of fair value and not because of their weight in an index. Another problem with an index benchmark is that a company's and a country's weight in the index increase as valuations get higher. As value investors, we prefer the opposite – as a company becomes more expensive, the position size in the strategy should reduce. A year ago, when valuations in Vietnam were much lower than what they are today, Vietnam accounted for less than 10% of the MSCI Frontier Markets Index. Today Vietnam is more than 15% of the index.

We believe there are a number of very attractive opportunities across the frontiers universe. We hold investments that trade below our assessment of intrinsic value and we size our positions according to the return opportunity on an absolute basis, irrespective of the size of these investments in any particular benchmark. By doing so, we believe that the strategy will deliver attractive long-term returns to our investors.

CORONATION GLOBAL BOND FUND

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Oct 09	7.50%	5.03%	2.56%	3.72%
Benchmark		6.97%	3.31%	1.10%	1.61%

Annualised, quoted in USD
Sources: Coronation, Bloomberg

The fund returned 1.2% for the quarter and 7.5% over the last 12 months, against a return of 1.4% and 7.0% respectively from the Bloomberg Barclays US Aggregate Bond Index.

US yields continued to rise over the quarter and US government bonds were by far the weakest of the major markets, with a total return of -1.2%. German yields rose modestly, but the income generated was sufficient for German government bonds to post a modest total return. Elsewhere, peripheral Europe and a number of emerging markets posted healthy gains despite the rise in volatility. While corporate bonds performed well during January, credit spreads widened during February and March, to the extent that they underperformed government bonds for the quarter, the first time since the end of 2015.

Global growth is currently in a sweet spot, benefiting from a cyclical upturn in all major regions, and running at its fastest rate since 2011. The question is where the risks of a slowdown may emanate from. Will it be the return of inflation that prompts a more rapid tightening of monetary policy, or will it be geopolitical (the risk of a looming trade war)?

After the passage of the US tax bill, the country's trade deficit has now become the focus of the Trump administration. Renegotiating the North American Free Trade Agreement (NAFTA) may have been a first salvo, but more recently the imposition of tariffs on a range of imported products has riled allies, adversaries and investors. In addition, there are signs in many regions of more protectionist attitudes to national industry champions. Taken together, these actions in an economy growing above its potential

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are more likely to see price pressure increase. While tensions on the Korean peninsula appear to be easing, risks in several other geopolitical hotspots threaten market sentiment, most likely via rising energy costs.

The upward movement in US Treasury yields during the quarter reflected the impact of the passing of the tax legislation, with market participants upgrading economic forecasts for 2018 and 2019, and investors expressing concerns about the increasing size of fiscal deficits. US 10-year yields peaked at close to 3.0% in February before retracing slightly to 2.7% by quarter-end, having closed 2017 at 2.4%. The yield curve continued to flatten as shorter-dated yields rose most. With breakevens relatively stable, the bulk of the sell-off has come from rising real rates, with 10-year real yields rising to 0.7% over the quarter. The Federal Open Market Committee (FOMC), led by the new chair Jerome Powell, raised rates in March by a further 0.25%, with the upper bound of the US Federal Reserve (Fed) funds target range now at 1.75%. The FOMC also amended its growth projections upwards to 2.7% in 2018 (from 2.5% in December and 2.1% pre-tax cuts) and 2.4% in 2019 (up from 2.1%). Its unemployment rate forecast fell slightly in 2018, and was lowered to 3.6% in 2019 and 2020. This would be consistent with the lowest unemployment rate since the late 1960s. Some investors have begun to draw parallels with policies of the Nixon administration and worry that the twin deficits will lead to a loss of confidence and a weaker dollar, as was the case in the early 1970s. The FOMC also adopted a slightly more hawkish stance in its projection of interest rates, with the dot plot rising from 2.688% in December to 2.875% in March, and 2020 projections increasing from 3.062% to 3.375%.

While official rates may have only increased by 0.25%, rates in the interbank market have been rising much faster. The 3 Month USD Libor spread has risen to 0.6% (from 0.3% at the end of December) as a result of several factors coming together. Part of this is driven by much higher Treasury bill issuance, following the resolution of the debt ceiling (further exacerbated by the Fed shrinking its balance sheet). The other element has been more supply from banks and less demand from corporates as a result of changes in the US tax system. The result is that the 3 Month USD Libor has risen 1% in the last six months. At 2.3%, it is now a credible alternative for investors who may not want exposure to longer-dated Treasuries, which are more volatile and does not carry a much higher yield at present.

We believe the Fed's 2020 forecast for its funds rate now looks overly aggressive. We remain wary of valuation in longer maturities, which we believe will face growing headwinds from rising supply and less support from overseas buyers, as hedging costs have increased. The fund switched its remaining mid-curve exposure to the five-year area of the curve and switched its inflation-linked bonds into conventional fixed rate Treasuries. Total US Treasury exposure was reduced as the fund increased exposure to emerging markets and credit.

Global growth is currently in a sweet spot, benefiting from a cyclical upturn in all major regions, and running at its fastest rate since 2011.

European government bond markets performed well during the quarter, led by the periphery despite an Italian election in March that resulted in a hung parliament. Coalition talks continue in Italy after a month-long stalemate that has failed, so far, to bridge the gap between parties of very different political persuasions. Political risk has subsided in Spain for now. The ostracised Catalan leader Carles Puigdemont, who was forced to flee Spain, has so far escaped attempts by Madrid to extradite him from Germany. On the economic front, momentum has slowed to its weakest level in more than a year as the composite Purchasing Managers' Index fell abruptly in February and March. Indications still suggest annual growth in the region of 2.5% and some of the weakness may be in part explained away by weather, supply chain bottlenecks and unusually high levels of absenteeism due to flu. The slowdown comes at a delicate moment for the European Central Bank as policy-makers debate further tapering of their bond buying programme. Meanwhile, inflationary pressures remain modest despite evidence of a firming of some underlying elements, such as within services.

With respect to Brexit, in March the UK reached an agreement that a 21-month transitional period would begin in March 2019, giving the impression that headway is being made in discussions with the EU. However, some of this progress is viewed by Eurosceptic members of parliament (MPs) as merely the result of a compromise of previous 'red lines'. While markets have become more optimistic that a manageable 'muddle-through' result will ultimately be achieved, the chances of a 'no deal' because of future insurmountable hurdles, or the failure of a final deal to be ratified by MPs remain significant. In the mean time, inflation remains above target at a time when slack in the economy has reduced and wage pressures are picking up. A further rate increase is widely expected by the market in May, with tightening thereafter likely to be heavily dependent on whether global growth (and in particular the EU) remains above trend. Cooling house prices (albeit London-focused) and sluggish retail sales are symptomatic of the high level of indebtedness, a decline in real wages and economic uncertainty among consumers.

Emerging markets hard currency debt performed well during the quarter, despite a backdrop of weaker corporate bonds. The US-dollar denominated emerging markets debt spreads ended the quarter only 10 bps wider at 320 bps. Local currency denominated debt performed well this quarter, up 4.7% in US dollar terms.

The star performers include South Africa (up 8.6% in local currency and 13.5% in US dollar terms) and Mexico (up 3.6% in local currency and 11% in US dollar terms). Higher inflation in the Philippines resulted in a weakening of bond yields and foreign exchange markets (resulting in a combined loss of 8% in US dollar terms), while bond market returns in Turkey and Argentina suffered against a backdrop of weaker exchange rates as investors perceived politicians to be compromising the independence of their central banks. The fund increased its exposure of predominately short-dated dollar instruments, adding to positons in Argentina and Qatar as well as switching Turkish and South African government exposure to slightly longer-dated instruments to take advantage of a steep credit curve. The fund recently added exposure to local currency Turkish government bonds where yields are now high.

Credit spreads remain relatively tight but have begun to soften slightly under the weight of supply and a less supportive equity backdrop. The weakness in corporate bonds was not limited to the US market, and euro and sterling spreads also widened. It is noteworthy that since central banks' asset purchases have begun to be reduced, markets have struggled to extend their gains.

At this stage, we continue to see the immediate risk to valuations as more dependent on changes in the flow of funds into the asset class (exchange-traded funds and passive investment are significant in this regard) than solvency related. The more fundamental credit challenge will come as central banks adjust policy rates higher, the world economy begins to slow and large amounts of refinancing come due (in 2019 and 2020). After the recent move, we are more constructive on shorter-dated corporates but remain cautious of longer-dated instruments. The fund added to its credit exposure via Sasol during the quarter and via convertibles such as Intu Properties, Impala Platinum and Redefine Properties.

Within foreign exchange markets, the US dollar continued to struggle despite a continued widening in interest rate differentials. Within the G10, the yen was the best performer (up 6%) despite the Bank of Japan dismissing speculation that it may be beginning to consider tapering its stimulus programme. The Norwegian krone also performed well after the central bank lowered its inflation target from 2.5% to 2%. With inflation now above the new target, the central bank suggested a rate hike was likely as soon as September. Sterling also rallied against the US dollar (up 3.7%) just ahead of the euro (up 2.5%). The Canadian dollar was among the weakest currencies, as expectations for rate rises moderated and concerns surrounding NAFTA weighed on the currency, despite Mexico being the best-performing currency.

The fund remains slightly overweight US dollars and neutral yen. An underweight position in euros remains the main funding currency for positions in emerging markets that include Mexico, Turkey and Egypt, and to a reduced extent, South Africa.

The fund remains underweight duration, predominately via low duration positions in Europe and no Japanese bond exposure. We retain a preference for shorter-duration positions within government and credit markets within the US. The fund's exposure to mainstream credit remains low, with our exposure to higher yielding assets expressed via convertibles and emerging market debt. We expect the recent pickup in volatility to continue as central bank liquidity is drained from the system. ✚

Global strategy performance

	LAUNCH DATE	SINCE INCEPTION	1 YEAR	5 YEARS	10 YEARS	15 YEARS
EMERGING MARKETS EQUITY						
Global Emerging Markets Equity Strategy	Jul-08	8.12%	24.63%	5.63%	-	-
Coronation Global Emerging Markets Equity Benchmark		3.88%	24.93%	5.19%	-	-
Alpha		4.24%	(0.30%)	0.44%	-	-
GLOBAL FRONTIERS						
All Africa Strategy	Aug-08	10.11%	43.40%	6.18%	-	-
3 Month USD Libor		0.66%	1.51%	0.66%	-	-
Alpha		9.45%	41.89%	5.52%	-	-
Africa Frontiers Strategy	Oct-08	11.23%	45.59%	6.46%	-	-
3 Month USD Libor		0.62%	1.51%	0.66%	-	-
Alpha		10.61%	44.08%	5.81%	-	-
Global Frontiers	Dec-14	9.02%	38.05%	-	-	-
3 Month USD Libor		0.86%	1.51%	-	-	-
Alpha		8.15%	36.54%	-	-	-
GLOBAL						
Global Equity Fund of Funds*	Jul-00	6.79%	16.30%	10.64%	8.55%	11.87%
Coronation Global Equity FoFs Benchmark		4.80%	14.85%	10.33%	6.52%	9.75%
Alpha		1.99%	1.45%	0.30%	2.03%	2.12%
Coronation Global Strategic Income	Jan-12	3.40%	2.18%	2.41%	-	-
110% of 3 Month USD Libor		0.67%	1.66%	0.72%	-	-
Alpha		2.73%	0.52%	1.68%	-	-
SOUTH AFRICA						
Houseview Equity Strategy USD	Oct-93	11.34%	18.48%	4.50%	8.50%	17.09%
Houseview Equity Benchmark in USD		8.93%	23.53%	4.79%	6.09%	14.72%
Alpha		2.41%	(5.05%)	(0.29%)	2.41%	2.37%
Top 20 USD	Oct-00	17.61%	20.96%	5.01%	10.30%	19.14%
Coronation Top 20 Fund Benchmark in USD		11.21%	23.53%	5.01%	5.16%	14.00%
Alpha		6.40%	(2.57%)	(0.01%)	5.14%	5.15%

** Strategy performance figures are quoted after the deduction of management fees levied within the strategy*
Figures are quoted as at 31 March 2018
Sources: Coronation and JP Morgan
Past performance is not necessarily a guide to future returns