EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

SEPTEMBER 2017

THE LAST THREE YEARS HAVE BEEN UNUSUAL

Equities, bonds and cash have barely beaten inflation over the past three years. Further, with the three asset classes having delivered similar returns (roughly 7%) over this period, investors were not compensated for taking on additional risk.

Asset class returns – periods ending 31 August 2017

	1 year	3 years	5 years	10 years
Domestic				
ALSI	10.1%	6.6%	13.1%	10.2%
SA Money Market	7.6%	7.0%	6.4%	7.3%
SA All Bond Index	10.2%	6.7%	6.3%	8.6%
SA Listed Property	9.4%	13.0%	11.7%	14.6%
CPI	4.8%	5.1%	5.6%	6.1%
ZAR/USD	12.9%	-6.4%	-8.4%	-5.8%
Global				
ACWI (ZAR)	4.3%	13.5%	21.2%	11.3%
US T-Bills (ZAR)	-10.9%	7.2%	9.4%	6.6%

Source: Coronation

We don't believe this environment to be normal, however, and given the opportunities we are starting to see in the market today, we expect the situation to revert to one where equities will again start to deliver excess returns to compensate investors for the additional risk taken.

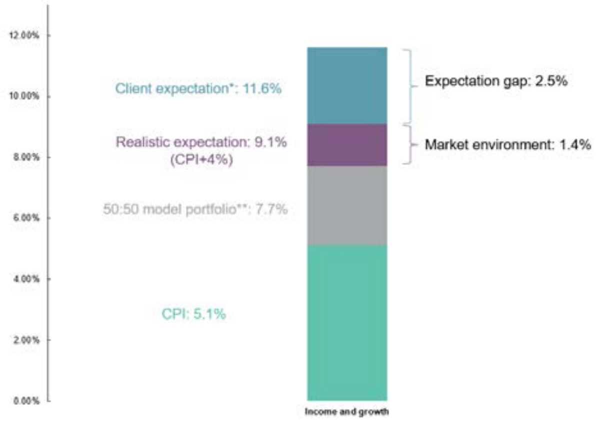
As always, a note of caution should be added when evaluating returns over a relatively short space of time. At the time of writing, the 7% average return from equities over three years mentioned above have morphed into a 10.4% per year, while cash and bonds are still at 7% p.a.

ACKNOWLEDGING THE RETURN EXPECTATIONS GAP

Despite the disappointing returns delivered by equities and bonds (the main building blocks of a multi-asset portfolio), insights from a recent client survey showed that the return expectations for absolute return funds err on the high side. In fact, return expectations for income-and-growth funds are almost similar to that of long-term growth funds - an unrealistic assumption given the significantly lower risk budget deployed by funds in the income-and-growth category. In our view, a more realistic return expectation for our absolute return funds is CPI plus 4% (in the case of Capital Plus) and CPI plus 3% (in the case of Balanced Defensive). Unfortunately, over the past three years this was a near impossible target to achieve given the mediocre returns delivered by the underlying building blocks.

As a result of client expectations not being met, we've seen significant outflows from the income-and-growth category at industry level. These flows have largely been channeled into managed income funds and cash deposits. The thinking driving this behaviour is typically that if you are able to achieve the same level of return from lower risk options, why would you need to take on additional (unrewarded) risk and invest in a fund with exposure to growth assets? The implicit assumption made by investors reaching this conclusion is that the experience of the recent past will continue to repeat in future.

Acknowledge the expectation gap



Source: Coronation

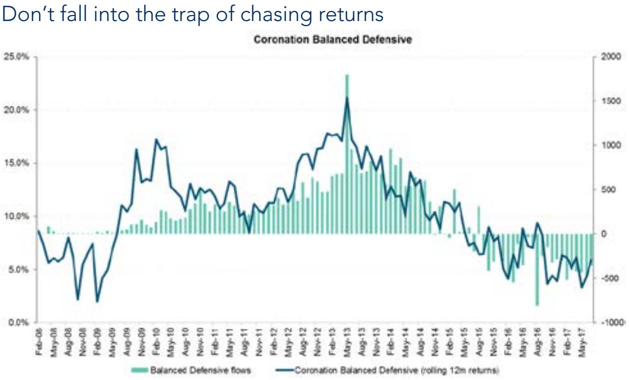
* *Average return expectation for existing investors in our income-and-growth funds that participated in a survey conducted during June and July 2017*

*** 50:50 model portfolio used as proxy for income & growth fund with asset allocation set at 35% local equity, 10% global equity, 5% local property, 35% local bonds and 5% local cash*

Ultimately, we strongly believe that the key risk that more conservative income-and-growth investors need to avoid – counter-intuitively - is not taking on enough risk.

Investors need exposure to growth assets to be able to maintain their spending power through retirement. Further, investors should avoid falling into the trap of chasing returns as is clear from the graph below. Investors tend to commit capital when returns *have* been good and withdraw *after* they experienced a tougher time. We don't believe this to be an appropriate investment strategy for long-term investors. Ultimately, one requires the patience to look beyond any short-term pain and avoid locking in any losses by selling low and buying high.

Don’t fall into the trap of chasing returns



Source: Coronation

WHAT DOES THE MACRO BACKDROP LOOK LIKE?

The global economy has been marked by steady and improving growth; continued low inflation; and as a consequence low interest rates, which provided a good backdrop for the valuation of risk assets.

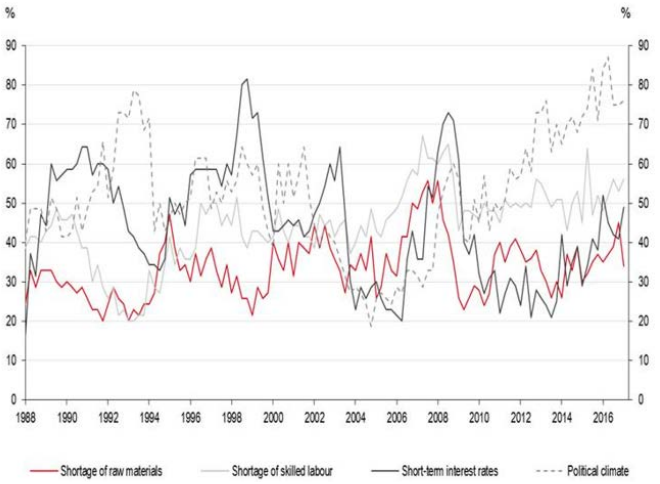
While this has resulted in decent outcomes from global markets, there are a couple of risks in the system. The first is the impact that a wave of US protectionism or an acrimonious divorce in Europe will have on the global economy.

Secondly, from a geopolitical perspective, there is the ongoing threats of nuclear war between the US and North Korea.

Looking at South Africa, we have our own diverse set of problems. The country is facing a crisis of confidence. South Africans are very unsure about the future, which means they are not committing new capital to investing, ultimately stifling economic growth. This lack of confidence is mostly due to the squandering of money by government, coupled with bad decisions and poor capital allocation. Low confidence levels also affect spending, which impacts employment.

According to the Bureau for Economic Research's consumer confidence index, more than three-quarters of manufacturing firms see the political climate as a constraint to doing business in South Africa.

Politics major cause of current pessimism



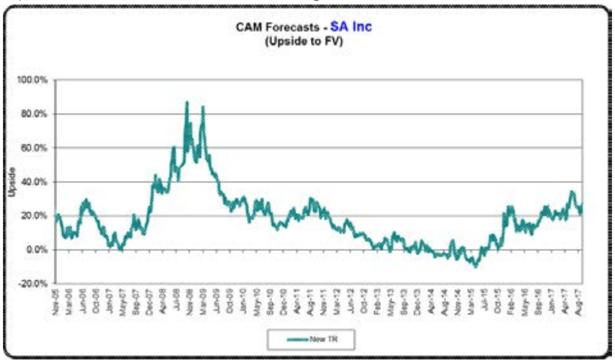
Source: Bureau for Economic Research

INVESTMENT OUTLOOK AND PORTFOLIO POSITIONING

When building our portfolios, we are not overly fixated on the macroeconomic outlook. We are more upbeat about domestic equities than we were three years ago when the market was expensive. There are many South African businesses for which the returns going forward look better than they have for quite some time. Most of that has to do with the fact that the base is so low. If our macroeconomic outlook improves just a little bit, and companies are able to improve their topline only by a small margin, one can easily expect to see a decent improvement in earnings.

The green line in the graph below represents our expected upside to fair value, one year forward. At times in 2007/8, 2014 and 2015, we had low expectations for returns going forward. The key reasons include the fact that valuations were stretched (both price/earnings-multiples and the earnings base were high). Our assessment of expected return has edged up as the market de-rated and we now see upside in line with the historical average. This makes it more probable that the equity market (and therefore funds with growth asset exposure) will meet realistic return expectations over the next several years.

Upside to fair value as at end August 2017



Source: Coronation

We also see value in the UK-listed properties listed on the JSE (Capco, Intu and Hammerson) for which the market has discounted the worst case scenario (i.e. a really bad divorce from Europe). Locally, we continue to favour the high-quality listed property companies such as Growthpoint.

In terms of our offshore exposure, we maintain fairly decent exposure even though we have reduced our equity holdings due to extended valuation levels in global markets and the 'Trump' risk of more protectionism and geopolitical miscalculation mentioned above.

Within our fixed income allocations, we continue to favour corporate credit to government or SOE debt and prefer floating-rate instruments to keep duration risk low.

HOW DO WE MANAGE OUR INCOME-AND-GROWTH FUNDS?

Capital Plus and Balanced Defensive follow an absolute return investment strategy, which focuses on both delivering competitive returns over time while managing the risk of capital loss over the shorter term. These funds target outperformance of inflation* - not a specific index or the returns of our competitors. While the funds are reliant on a positive performance from growth assets to meet their return objectives, the portfolios are managed to provide a high probability of preserving capital when markets are falling.

Risk is measured as not losing money and our funds aim to preserve capital over any rolling 12-month period (in the case of Balanced Defensive) or – going forward* - any rolling 18-month period (in the case of Capital Plus). In its 10-year history, Balanced Defensive has never lost money over any rolling 12-month period, while Capital Plus has achieved positive returns over one year 96% of the time. The fund has never lost money over any rolling 18-month period.

We consider downside risk in every investment decision – as is evident in our broadly diversified asset allocation across equities, bonds (inflation-linked, credit, government), preference shares, commodities, property and international assets. We limit exposure to individual companies and specific risk factors to avoid building portfolios that are overly reliant on just a few ideas. We also use other tools to protect against loss, including buying downside protection (using derivatives) when priced appropriately. Currently, for example, we use protection in the form of put options for Capital Plus, which has double the SA equity holdings of Balanced Defensive. Like insurance, put options can protect the funds against big downturns, in exchange for paying the option premium to the issuer.

**as discussed in more detail in the respective fund commentaries*

HOW DID THE FUNDS PERFORM?

Our portfolios are managed for the long term. While we are disappointed by the short-term returns, we remain encouraged by the real returns delivered by both funds over meaningful periods (five years and longer) as illustrated below.

Coronation Balanced Defensive Class P – performance to end August 2017

Return	1 year	3 years (p.a.)	5 years (p.a.)	10 years (p.a.)	* Since inception (p.a.)
Coronation Balanced Defensive Fund	4.8%	7.2%	10.0%	10.5%	10.4%
Real Return	0.0%	2.1%	4.3%	4.4%	4.2%
Peer group average**	4.7%	6.5%	8.3%	8.0%	8.0%

Coronation Capital Plus Class P – performance to end August 2017

Return	1 year	3 years (p.a.)	5 years (p.a.)	10 years (p.a.)	* Since inception (p.a.)
Coronation Capital Plus Fund	4.2%	5.5%	9.7%	9.5%	12.9%
Real Return	-0.6%	0.4%	4.0%	3.4%	6.9%
Peer group average**	3.9%	5.9%	9.2%	8.0%	11.2%

Source: Coronation

KEY CONSIDERATIONS WHEN MANAGING INCOME-AND-GROWTH PORTFOLIOS

Ensure the drawdown rate is appropriate

Studies have shown that if you can get through the first 10 years of retirement with your real capital intact, you will have a high probability of maintaining your standard of living in the second half of retirement.

The following slide plots hypothetical return expectations versus drawdown rates. The highlighted numbers in the middle show the amount of years you have left before you will start to eating away at your retirement capital (assuming inflation of 6%).

Income rate and return analysis – years before your income will start to reduce if inflation is 6%

		Nominal net investment return p.a.					
		2.5%	5.0%	7.5%	10.0%	12.5%	15.0%
Selected income rate p.a.	2.5%	21	30	50+	50+	50+	50+
	5.0%	11	14	19	33	50+	50+
	7.5%	6	8	10	13	22	50+
	10.0%	4	5	6	7	9	20
	12.5%	2	3	3	4	5	7
	15.0%	1	1	2	2	2	3
	17.5%	1	1	1	1	1	1

Many retirees are drawing 5%-7.5% & expecting returns of 12%.

Note how sensitive their income security is to a 2.5% decline in expected return!

Source: Asisa Standard on Living Annuities with additional calculations by Coronation

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As we have highlighted before, many retirees are expecting returns in the region of 12.5%, and drawing and income of 5% - 7.5%, believing their capital will comfortably last for a full retirement. However, they may not be aware just how sensitive their income security is to a change in expected return of as little as 2.5%, reducing the sustainability of their retirement income dramatically.

The prudent recommendation remains for initial drawdown rates to be set in line with the rates quoted for CPI-linked underwritten annuities, which is currently in the region of 4% - 5% for those starting to draw an income in their early sixties.

You need enough exposure to risk assets

Investors requiring an income over a long time horizon need enough risk asset exposure to achieve reasonable real growth over time, but not so much that a near-term market correction impairs your capital base. Capital Plus (with a 70% growth asset limit) and Balanced Defensive (with a 50% growth asset limit) are managed in a manner that is consistent with this requirement.

Beware the retiree's investment horizon

Your investment time horizon is key, especially given the short-term focused world in which we find ourselves. Even post-retirement, life expectancy continues to increase meaning most retirees need to plan for the possibility of spending three decades or even longer in retirement. Your key objective must be to sustain your standard of living over a full retirement. The most appropriate investment solution in most cases will be one that is long-term in nature.

OVERCOMING THE INCOME-AND-GROWTH CHALLENGE

The following considerations may prove useful when considering the difficult trade-offs retirees need to make:

- *Have reasonable and prudent return expectations:* Target a real return consistent with an appropriate risk budget and do not anchor off very favourable historic returns.
- *Manage inflation risk:* While inflation is currently relatively low, it remains a real risk given the uncertainties inherent in small, open and fragile economy on the southern tip of Africa. You need to ensure that you have healthy allocations to growth and international assets to give you the best chance of achieving inflation-beating returns in the long run. In addition, by investing with a manager that can deliver alpha over the long term, you may obtain a sweetener over and above the market return.
- *Manage the sequence-of-returns risk:* A big market drawdown can have a material impact on your portfolio and your standard of living post-retirement. Managing sequence of returns risk is thus important. Don't be lulled into misplaced complacency by the low volatility of the post-crisis years into underestimating the importance of downside protection.
- *Manage longevity risk:* The likelihood of living longer must be taken into account when setting your retirement plan. Insuring longevity risk, moderating initial draw-down rates, or working a little longer are all more appropriate responses to managing this risk than naively setting unrealistic return expectations from your investment portfolio.