ISSUE 24

CORO.LAB

Your guide to investment ideas

INVESTING FOR LONG-TERM CAPITAL GROWTH

Featuring Coronation's range of long-term growth solutions

CORONATION
TRUST IS EARNED™

INVESTING FOR LONG-TERM CAPITAL GROWTH

Investors looking to achieve long-term capital growth have one great advantage – time. Money invested generates returns that can be reinvested to achieve further returns (this process enables compound growth). Given that compounding is an exponential rather than a linear function, the longer investors have to invest the greater the possibility of dramatically multiplying their purchasing power. When investing to fund a retirement, investors' investment horizons are measured in decades rather than years. This makes optimal decision-making counter-intuitive to the short-termism that drives most market participants.

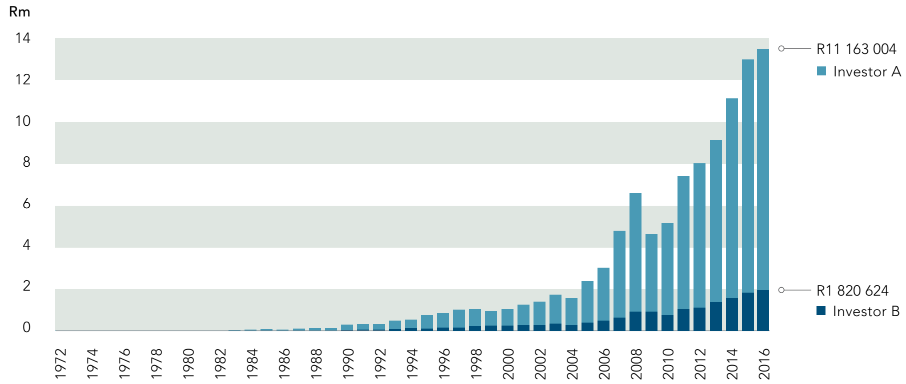
This issue looks at why we believe a long time horizon is the most reliable investment strategy for investors looking to achieve above-average results. We outline investment concepts that drive investor outcomes over the long term, discuss the importance of asset allocation and diversification, and consider the implications of our long-term return expectations on a typical balanced fund. Finally, we present our range of long-term growth solutions aimed at meeting the needs of different investor profiles.

CONCEPTS THAT DRIVE INVESTOR OUTCOMES OVER THE LONG TERM

COMPOUNDING

The power of compounding is critical to long-term wealth creation. To highlight the effect that compounding has over long periods of time, consider the following scenario: Investors A and B started their careers on 1 April 1972 when both were 21. Investor A decided to invest R100 per month in the domestic equity market (FTSE/JSE All Share Index) from age 21 to 31. At 31 she elected to stop her monthly contribution, but left her accumulated capital in the equity market until retiring on 31 July 2016 at the age of 65. Investor B also invested R100 per month in the same equity market, but only started on 1 April 1981 at age 31. He then continued to diligently contribute that same amount per month until he also retired on his 65th birthday on 31 July 2016 (i.e. contributing for a period of 34 years).

>> FIGURE 1 THE POWER OF COMPOUNDING



Source: Coronation Fund Managers (end values calculated as at 31 July 2016)

The important point to note, as illustrated in Figure 1, is the significant difference between the end values for each investor. At 65, Investor A, who only contributed for a period of 10 years and then left the investment to compound over a period of 34 years, had accumulated an amount of more than R11 million, which is six times more than that of Investor B who contributed for 34 years, but started 10 years later (and had just more than R1.8 million).

TIME DIVERSIFICATION

A long time horizon allows investors to have a larger risk budget - making it possible to have more exposure to growth assets with higher expected returns and the attendant variability from year to year.

In *The Effective Investor* (Pan Macmillan, 2009), Franco Busetti writes that 'after compounding, time diversification of risk is your second-best friend in the market'. The concept of time diversification refers to the decrease in risk of holding growth assets as an investor's investment time horizon increases.

Take for example an investment in equities. Given the volatility inherent in this asset class, the possibility of suffering a capital loss in any one year is far greater than if you were invested in cash or bonds. However, the longer the investment period, the lower this variability becomes.

The adjacent figure shows the range of returns achieved by the FTSE/JSE All Share Index over different investment time horizons (rolling 5 years, 10 years, 15 years, etc.). While the average returns achieved are similar, the range of returns (low versus high) progressively narrows as the investment time horizon increases.

Armed with the knowledge that there is time to recover from periods of poor performance makes it easier for investors to follow a buy-and-hold strategy. This is the best way to avoid missing out on returns earned during market recoveries, which most often happen quickly and unexpectedly.

>> FIGURE 2 RANGE OF RETURNS OVER ROLLING PERIODS (FTSE/JSE ALL SHARE 1960 – 31 JULY 2016)

Source: Busetti (The Effective Investor, 2009) with additional calculations by Coronation

THE IMPORTANCE OF AVOIDING NEGATIVE RETURNS AND FOCUSING ON LONG-TERM CUMULATIVE PERFORMANCE

In the performance assessment process, our evolutionary biases make us prone to place too much emphasis on recent performance and the consistency of outperforming market indices, but don't give enough credit to managers who can preserve value in down markets.

The following case study talks to some of the pitfalls in assessing investment performance. Figure 3 shows three hypothetical scenarios in which the market delivers a cumulative return of only 6% over five years. In the first scenario, the 'steady fund manager' delivers the perceived holy grail: consistent outperformance of 4% every single year. In the second scenario the 'lumpy fund manager' delivers the same aggregate alpha* over the five years of 20%, but its performance is lumpier. In scenario 3 the 'bear market manager' also delivers the same aggregate active return, but does it all in the first year (which happens to be the only down year in the period).

Over the full period, the final outcomes for the three managers' clients are materially different and completely at odds with what we intuitively would have expected! The 'steady manager' delivered a compelling cumulative return of 31%, the 'lumpy manager' did even better with 39%, but the 'bear market manager' did best with 49%.

>> FIGURE 3 HYPOTHETICAL COMPARISON OF FUND MANAGERS

	Year 1	Year 2	Year 3	Year 4	Year 5	Average alpha	Aggregate alpha	Arithmetic average	Cumulative return
Market return	(50%)	40%	15%	15%	15%	—	—	7%	6%
1. Steady manager	(46%)	44%	19%	19%	19%	4%	20%	11%	31%
2. Lumpy manager	(40%)	35%	25%	10%	25%	4%	20%	11%	39%
3. Bear market manager	(30%)	40%	15%	15%	15%	4%	20%	11%	49%

Source: Coronation Fund Managers

What this case study demonstrates is that as much as we desire consistent outperformance year in and year out, the 'steady manager' ultimately delivered the lowest value-add, beaten by the 'lumpy manager' whose alpha* was more inconsistent. But ultimately, the manager who did best was the one that delivered in a down year and then delivered only the market return for the next four years.

As observers, our expectations of cumulative performance are often very different from reality. This is why Coronation so consistently argues that it is the cumulative, long-term performance of an investment house that matters. Assessment periods of less than five years have little value. They usually reflect only one part of a market cycle and don't capture what really matters: the actual capital accumulated by clients over the full period of their investment with that fund manager.

***Alpha**

The industry term used to describe the difference between the return of an actively managed fund and that of the market index. In the case of Coronation's unit trust funds, we always show alpha after all management fees and fund costs have been taken into account. If the investor receives zero alpha, it means the earned return is equal to that of the market.

ASSET ALLOCATION AND DIVERSIFICATION

Investment markets are not static. New opportunities arise as companies, industries, countries and asset classes develop and contract. Relative valuation levels between local, developed market and other emerging market assets, as well as between equities, bonds and cash, change over time. The emergence of new asset classes such as inflation-linked bonds, or a deepening of an existing asset class through new listings and more activity (as was the case in the domestic listed property market) add to the investable universe. Regulations that restrict or enhance the freedom to invest in foreign markets change. Investors can therefore enhance their eventual outcomes by making good strategic and tactical asset allocation decisions in response to this dynamic environment.

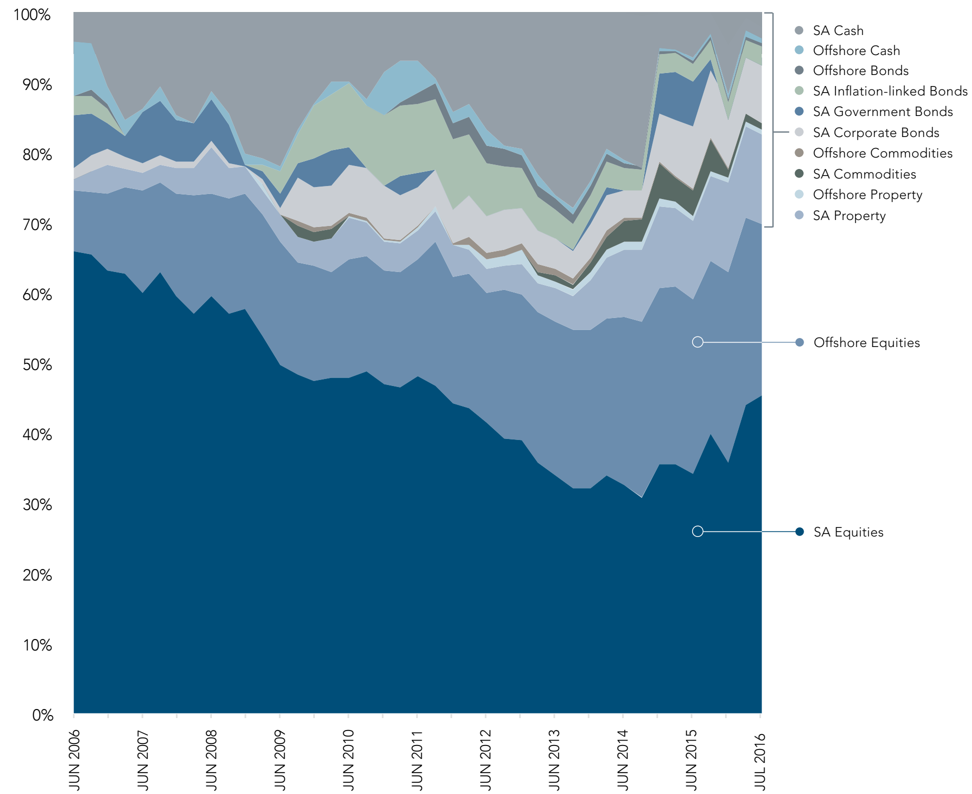
While equities typically have the highest expected return over time (as we will illustrate in Figure 8 on page 14), this is not always the case. Market price levels can change both for fundamental (i.e. sustainable earnings and dividend growth) and sentimental reasons (i.e. investors in aggregate are more/less optimistic and hence prepared to apply higher/lower ratings to companies). This insight supports the use of a strict valuation discipline when deciding what the optimal portfolio structure should be, informed by the difference between current price levels and well-considered long-term fair values in different markets.

Figure 4 illustrates how the asset allocation of our flagship balanced fund, Coronation Balanced Plus, has changed over the past 10 years. The stand-out features are:

- Our comfort with temporarily holding relatively high levels of cash at times when we believe valuations to be stretched in higher return/higher risk alternatives such as bonds, property and equity; and
- The increase in offshore equity exposure over time, primarily at the expense of local equities. This trend was partly due to regulatory action, as exchange control limits were gradually relaxed to the current 25% foreign asset limit, but more importantly, driven by the more attractive relative valuation of global compared to local shares.

The return expectations underpinning the fund's current asset allocation are explained in more detail in the following section.

>> FIGURE 4 ASSET ALLOCATION FOR CORONATION BALANCED PLUS



Source: Coronation Fund Managers, data for the past 10 years to end July 2016

EXPECTED RETURNS

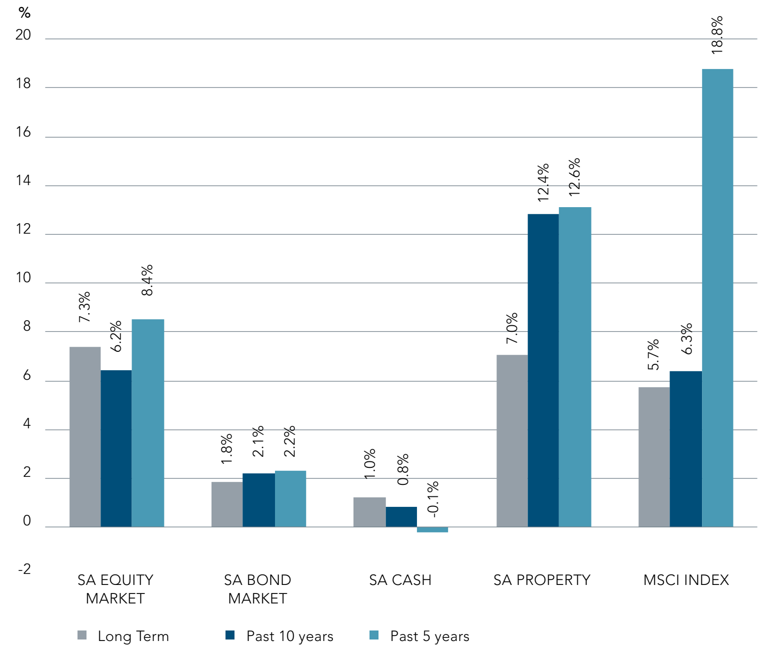
The expected rate of return on a portfolio of assets is an important, but difficult, input in the investment planning process. Important, because the investor's current contribution level with which he/she aims to achieve a specific investment objective in the future will vary dramatically based on the discount rate (or expected rate of return) selected. If you are too optimistic, the investor will end up with less purchasing power than required, but if you are too conservative, the investor will unnecessarily defer consumption, thereby reducing quality of life in his/her younger years. Difficult, because the future is by its very nature uncertain and we have at best partial information to inform our forecasts.

Note that the long-term saver is primarily interested in the real, or after-inflation, rate of return. Inflation measures the general increase in prices over time. If the rate of return selected equals the inflation rate, the investor is merely protecting the purchasing power of what has been saved. It is only the real return that can be viewed as a 'reward' for delaying gratification, as earning a positive real return will enhance an investor's eventual purchasing power.

A good starting point in setting prudent return expectations is to look at the very long-run asset class returns (Figure 5): growth assets (property and equity) produced a real rate of return in the 6% – 8% range, while income assets (cash and bonds) earned 1% – 2%. This implies an expected long-run real rate of return of around 5% p.a. for a typical balanced fund (assuming exposure of between 70% – 75% to growth assets and between 25% – 30% to income assets).

Actual real returns achieved over the past decade were, with the exception of SA property, in line with the long-term average, explaining why the typical balanced fund achieved a real return of around 4.5% - 5% p.a. Coronation Balanced Plus, due to a positive active return contribution, achieved a real return of around 7% p.a. over the same period.

>> FIGURE 5 ANNUALISED REAL RETURNS PER ASSET CLASS (PAST 10 YEARS AND 5 YEARS VS 116* YEARS TO 31 JULY 2016)



Source: Deutsche Bank, INET, Triumph of the Optimists – Dimson, March and Staunten
**Shorter history for foreign equities (46 years) and local property (36 years)*

Unfortunately, our view is that current market conditions, influenced by below-trend growth, extraordinary monetary policy accommodation and relatively full valuation levels make it likely that returns over the next decade will be below the long-term average. This leads us to a lower return forecast range for most asset classes (as set out in Figure 6). It also follows that over the next decade the average balanced fund is likely to produce a real rate of return below that of the long-run average. Based on the mid-point of our 10-year return expectations and asset allocation based on the composite index we use as the benchmark for Coronation Balanced Plus, it is prudent to assume a weighted real rate of return of around 2.5% - 3.0% p.a. for the typical balanced fund.

>> FIGURE 6 EXPECTED ASSET CLASS RETURNS

	PAST 10 YEARS (ZAR) %	10-YEAR FORECAST (ZAR)* %
LOCAL EQUITY	12.9	8 — 12
GLOBAL EQUITY	13.0	9 — 13
LOCAL PROPERTY	19.4	8 — 12
LOCAL BONDS	8.5	8 — 9
GLOBAL BONDS	11.7	4 — 6
CASH	7.5	7 — 9
INFLATION	6.3	6 — 7

*Source: Deutsche Bank as at 31 July 2016 and *Coronation Fund Managers forecasts as at 31 March 2016. While these forecasts are not guaranteed to occur, they are based on our best estimates of possible future returns and represent a more prudent basis for informing planning assumptions than historical results achieved over the past decade.*

IMPLICATIONS FOR INVESTORS

Figure 7 shows the increase in purchasing power at different real rates of return over time. If we use the 7% p.a. real return produced by Coronation Balanced Plus over the last decade as basis, we see an increase in purchasing power of 1.97 times over 10 years, and a very compelling 14.97 times over 40 years. However, if we reduce the real rate of return to 2.5% p.a., the increase in purchasing power falls to 1.28 times over 10 years and 2.69 times over 40 years. This is still a reasonable reward for delaying consumption, but an order of magnitude smaller than at the higher rate most recently achieved. Making imprudent assumptions about achievable real rates of return therefore makes it much less likely for investment objectives to be met.

>> FIGURE 7 INCREASE IN PURCHASING POWER

	REAL RATE OF RETURN (%. p.a.)			
INVESTMENT PERIOD IN YEARS	2.5	5	7	10
10	1.28	1.63	1.97	2.59
20	1.64	2.65	3.87	6.73
30	2.01	4.32	7.61	17.45
40	2.69	7.04	14.97	45.26

Source: Coronation Fund Managers

THE VALUE OF ACTIVE RETURNS

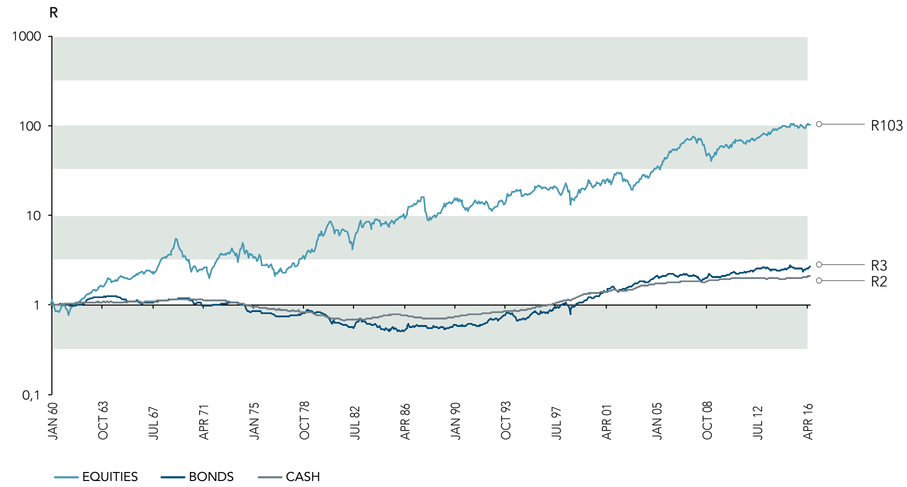
Coronation, like all active managers, pursues the outperformance of market indices or benchmarks (net of the fees we charge and costs that our portfolios incur). Since the launch of Coronation Balanced Plus in 1996, we have added 1.8% p.a. to the returns produced by its benchmark (comprising a combination of indices representing local and global equities, bonds and cash), and 2.5% p.a. more than the fund's average competitor. Both measures of outperformance are shown after the deduction of all our management fees and portfolio costs. If we are able to achieve a similar rate of outperformance in future, it could mean the difference between achieving a 2.5% and 5% real rate of return. Figure 7 on page 12 indicates that an additional 2.5% p.a. improves purchasing power by 25% – 30% after ten years, and nearly doubles purchasing power over 30 years.

THE CASE FOR BEING PATIENT

At Coronation, we have an unwavering commitment to investing for the long term. We believe an emphasis on valuation discipline over the appropriate time horizon increases the probability of achieving above-average returns. All our actions are aimed at ensuring that we analyse, debate and ultimately value businesses based on their long-term fundamentals. We do not chase share prices or constantly react to the most immediate news flow. By working hard to retain the trust of our clients, we are able to examine how a business performs through multi-year cycles, and this is what we believe gives us a distinct advantage over our average competitor.

Figure 8 illustrates the compelling results, in real terms, that are available to investors who are willing and able to put money in the equity market for very long periods of time (regardless of the sentiment of the day) and then let the power of compounding work for them (as detailed on page 2). While an investor who committed R1 to local bonds and/or cash would have seen an increase of 2-3 times in their purchasing power over the past 56 years, an equity investor who made the same commitment would be able to buy 103 times more today.

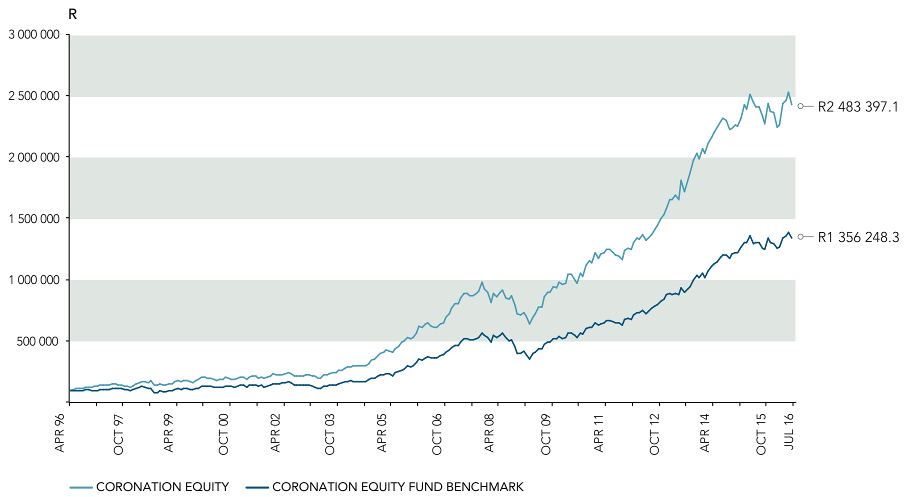
>> FIGURE 8 REAL PERFORMANCE OF SA EQUITIES, BONDS AND CASH (AS AT 31 JULY 2016)



Sources: Coronation Fund Managers, INET

In Figure 9 we illustrate the rewards of adding an active return (as discussed on page 13) to that of the market by having remained invested with Coronation over the long term. An investment in the local equity market 20 years ago would have grown your capital 13.6 times (in nominal terms), whereas a similar investment in the Coronation Equity Fund, which has outperformed the market by 3.2% p.a. after fees (a seemingly small number), would have grown your capital by almost 25 times.

>> FIGURE 9 CORONATION EQUITY



Source: Coronation Fund Managers

The conclusion is as simple as it is compelling. Invest in the equity markets for long periods of time, stick with winning fund managers for the long haul, and the power of compounding will do extraordinary things for you.

Yet most investors capture only a small fraction of the market return over time. This is because financial markets (and the performance cycle of a fund manager) typically turn when investors least expect them to. Often, the moves are large and, for that reason, a high percentage of the returns that patient investors earn over the long term are made in a surprisingly few trading sessions. For example:

- Since 1960 investors who were not invested in the SA equity market for 13% of those trading months received zero return over the 56-year period.
- Over Coronation's entire history as an investment house, investors who missed out on only 8% of our trading months received zero alpha over that 23-year period.

OUR LONG-TERM CAPITAL GROWTH SOLUTIONS

Coronation offers a range of funds specific to achieving long-term capital growth. These include both domestic and international multi-asset and equity-only funds as listed on pages 18 and 19.

We strongly believe that multi-asset class funds address the majority of investor needs and reduce the complexity of decisions the investor needs to make. They diversify risk across asset classes; reduce the risk of poorly timed asset allocation decisions, and allow investors to invest with a manager who has the skill and experience to invest beyond equities, bonds and cash into niche asset classes.

But not all multi-asset funds are the same. Different funds meet the needs of different investors. The level of risk that an investor is willing and able to take, as well as appetite for offshore exposure, will determine which fund is right for their needs.

CORONATION BALANCED PLUS	Ideal for pre-retirement investors as it is managed in line with the investment restrictions that apply to pension funds. Can invest up to 25% in offshore assets. This may be sufficient for investors who only have the budget to save for their retirement and do not plan to make any other discretionary investments.
CORONATION MARKET PLUS	Ideal for discretionary investors who are not saving within a retirement vehicle and are comfortable with a larger exposure to offshore assets, but still prefer their fund manager to decide on the allocation between domestic and offshore assets. Can invest up to 35% in offshore assets.
CORONATION OPTIMUM GROWTH	Ideal for discretionary investors who are not saving within a retirement vehicle and are comfortable with a larger exposure to offshore assets, but still prefer their fund manager to decide on the allocation between domestic and offshore assets. Can invest up to 100% in offshore assets, but typically holds between 50% and 90% offshore.
CORONATION GLOBAL MANAGED	A global balanced fund ideal for discretionary investors who prefer to be fully invested offshore and evaluate outcomes in hard currency terms. Invests in different asset classes and geographies with a bias towards growth assets in general and equities in particular.

For the more sophisticated investor who prefers to construct his or her own portfolio, we offer equity-only funds that can be used as building blocks, namely: domestic equity-only - Top 20 and Equity, and international equity-only - Global Emerging Markets, Global Opportunities Equity and the more recently launched Global Equity Select. Details on each fund are included in the following tables.

>> FIGURE 10 DOMESTIC MULTI-ASSET AND EQUITY FUNDS FOR LONG-TERM GROWTH INVESTORS

	EQUITY-ONLY	EQUITY-ONLY	MULTI-ASSET	MULTI-ASSET
FUND NAME	CORONATION TOP 20	CORONATION EQUITY	CORONATION BALANCED PLUS	CORONATION MARKET PLUS
BENCHMARK	FTSE/JSE Capped All Share Index (CAPI)	Composite: 87.5% local equity, 12.5% international equity	Composite: 67% equity (52.5% local and 14.5% international), 33% income assets (22.5% local bonds, 5.5% international bonds, 5% local cash)	Composite: 67% equity (52.5% local and 14.5% international), 33% income assets (22.5% local bonds, 5.5% international bonds, 5% local cash)
FUND DESCRIPTION	A focused portfolio of our top stock picks on the JSE.	Best equity view (less concentrated exposure than Top 20).	Best investment views across all asset classes for retirement savers.	Best investment views across all asset classes for discretionary savers.
LAUNCH DATE	October 2000	April 1996	April 1996	July 2001
ANNUAL RETURN (SINCE LAUNCH)	19.9% *15.3%	17.0% *13.7%	15.8% *14.0%	17.4% *14.6%
ANNUAL RETURN (LAST 5 YEARS)	14.2% *14.8%	15.4% *16.0%	14.4% *14.2%	15.0% *14.2%

**Benchmark return*

Figures are quoted from Morningstar as at 31 July 2016 for a lump sum investment and are calculated on a NAV-NAV basis with income distributions reinvested.

>> FIGURE 11 INTERNATIONAL RAND- AND DOLLAR-DENOMINATED MULTI-ASSET AND EQUITY-ONLY FUNDS FOR LONG-TERM GROWTH INVESTORS

	EQUITY-ONLY	EQUITY-ONLY	MULTI-ASSET	MULTI-ASSET
FUND NAME	CORONATION GLOBAL EMERGING MARKETS FLEXIBLE [ZAR] *CORONATION GLOBAL EMERGING MARKETS [USD]*	CORONATION GLOBAL OPPORTUNITIES EQUITY [ZAR] FEEDER *CORONATION GLOBAL OPPORTUNITIES EQUITY [USD]*	CORONATION GLOBAL MANAGED [ZAR] FEEDER *CORONATION GLOBAL MANAGED [USD]*	CORONATION OPTIMUM GROWTH
BENCHMARK	MSCI Emerging Markets Index	MSCI All Country World Index	Composite: 60% MSCI All Country World Index, 40% Barclays Global Bond Aggregate.	Composite: 35% local equities, 35% international equities, 15% local bonds and 15% international bonds
FUND DESCRIPTION	Best investment view across emerging markets.	Providing access to the best global equity managers.	Best investment view across global markets.	Best rand risk-adjusted returns from a global multi-asset portfolio.
LAUNCH DATE	December 2007	August 1997	October 2009	March 1999
ANNUAL RETURN (SINCE LAUNCH)	9.8% *7.1%	12.8% *11.6%	16.1% *16.1%	14.9% *12.0%
ANNUAL RETURN (LAST 5 YEARS)	13.8% *12.8%	23.1% *25.4%	21.7% 22.0%	21.0% *17.5%

**Benchmark return*

- *Rand- and dollar-denominated names included as a reference. Returns are quoted in ZAR.*
- *Figures are quoted from Morningstar as at 31 July 2016 for a lump sum investment and are calculated on a NAV-NAV basis with income distributions reinvested.*

>> NOTES

>> NOTES

For enquires you can call us on 0800 22 11 77 or email us at clientservice@coronation.co.za.

For new applications or transactions you can email your forms directly to transact@coronation.co.za or fax us on +27 21 680 2100.

For more information or to invest online, visit us on www.coronation.com.

DATE OF ISSUE: SEPTEMBER 2016

THE CORONATION CLIENT CHARTER

- We strive to always put our clients first
- We have an unwavering commitment to the long term
- We focus on producing top performance over all meaningful periods
- We are uncompromising about ethics

CORONATION
TRUST IS EARNED™