

2024

# INCOME INVESTING



# COROLAB

*Your guide to investment ideas*

**CORONATION**

TRUST IS EARNED™

A black and white photograph of three business professionals in a meeting. A man in a dark suit and white shirt stands in the background, looking towards the right. In the foreground, a woman with blonde hair is seated at a desk, smiling and looking towards the right. To her left, another woman is seated, looking towards the man. They are in a modern office setting with large windows in the background showing a hilly landscape.

## The Coronation client charter

- + We strive to always put 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



## Overview

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Income funds can play an essential role in your overall investment portfolio. Their purpose is to provide **a consistent and predictable income stream** from a portion of your overall portfolio where capital preservation may be needed.

It is, therefore, imperative for investors to **be clear about their chosen fund's expected return path** and to **understand the risks the fund will take** in order to arrive at that return profile.

The challenge is that:

- ▶ the investment universe for fixed income funds is complex, much more so than that of equities;
- ▶ not all income funds are of equal risk; and
- ▶ there are many fund options of which the return profiles vary greatly.

This edition aims to demonstrate why investing in income funds with a proven track record of delivering through various interest rate and market cycles, supported by a deep and experienced team with depth in terms of skills and experience, are key to delivering on the risk and return objectives for this conservative component of investors' portfolios.

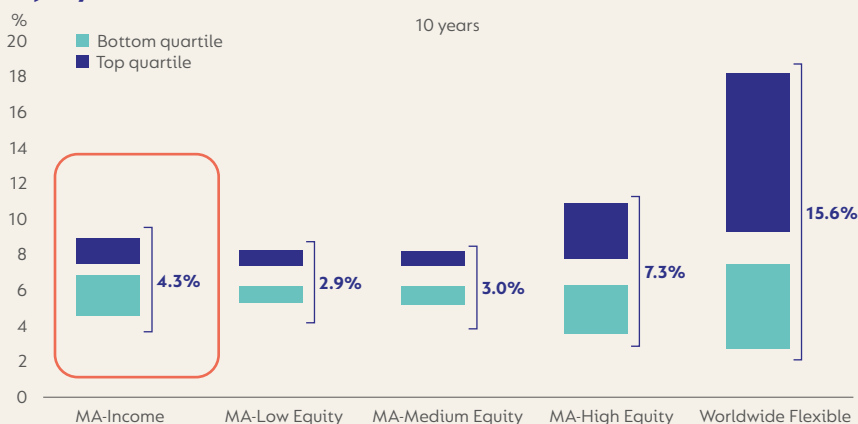
# What is an income fund and what return profile can you expect?

The **classic definition of an income fund** is one that aims to meet the needs (i.e., risk and return objective) of an investor seeking a conservatively managed fund that aims to outperform cash, or traditional money market funds, by 1% to 2% through the cycle, while aiming to preserve capital over the short term (typically 12 months). As such, investors will find income funds sitting somewhere between a money market fund and a bond fund on the risk/return spectrum.

The most popular type of income fund over the past decade has been managed income funds housed in the ASISA – Multi-Asset – Income category. These portfolios can invest in a wide variety of assets, such as cash, bonds, listed property and even equities, with the primary objective of maximising income on behalf of investors. The category allows for a high level of flexibility, with portfolios being able to invest as much as 45% offshore, 10% in equity and 25% in listed property.

One of the consequences of an increase in demand for this type of fund has been a wider (and less homogenous) set of available options compared to a decade ago, resulting in a much wider risk profile (and increasingly varying investor outcomes) as is clear from the graph below.

## Income fund return dispersion now greater than that of low equity funds



Source: Morningstar, Funds with AUM greater than R100m as at 31 December 2023



# Finding the right income fund for your needs

To help make it easier for investors to end up in the right income fund that meets their desired risk and return profile, we've amended our fund range over the past year by:

1. Enhancing disclosures to help investors understand the risk taken to achieve the funds' desired return. These improved disclosures include:

Our best-in-class fund disclosure	
Credit	<ul style="list-style-type: none"><li>➤ Breakdown of credit ratings</li><li>➤ Weighted average time to maturity</li><li>➤ Exposure to structured products</li><li>➤ Reference entity exposure</li><li>➤ Pricing frequency</li></ul>
Offshore	<ul style="list-style-type: none"><li>➤ Gross exposure</li><li>➤ Net exposure</li></ul>
Asset allocation	<ul style="list-style-type: none"><li>➤ Subordinated debt exposure</li><li>➤ State-owned entities exposure</li><li>➤ Structured product (CLN) exposure</li></ul>

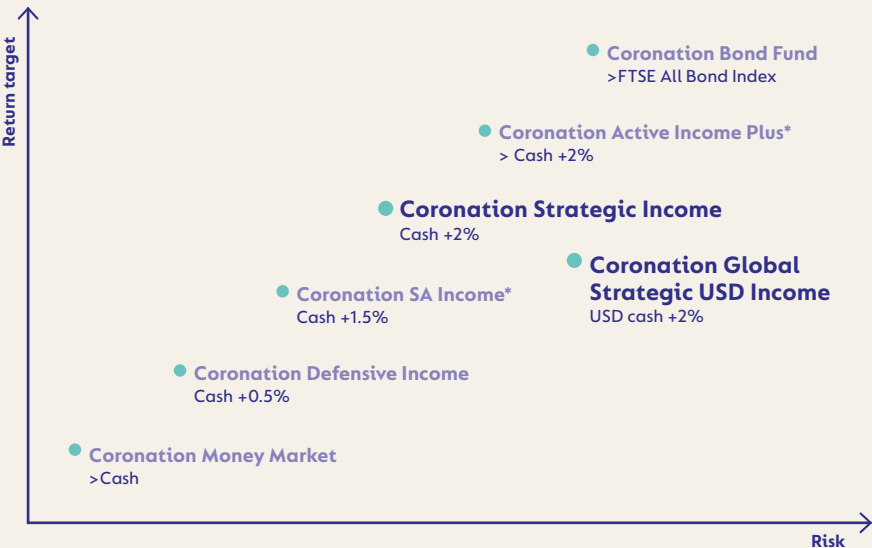
2. Calibrated our income fund range to the needs set of investors by launching **Coronation Active Income Plus** that has the freedom to invest in opportunities beyond the risk profile of a traditional managed income fund, but still aims to preserve capital over a 12-month period. We also launched a traditional income fund called **Coronation SA Income** that aims to provide a high yield from domestic fixed income assets only.

## Our range of risk-profiled income funds

Our range of income funds include four actively-managed multi-asset class funds – our flagship managed fixed income fund **Coronation Strategic Income** and its offshore equivalent **Coronation Global Strategic USD Income**, as well as the more recent additions **Coronation Active Income Plus** and **Coronation SA Income** (that invests in SA assets only).

All four funds were born out of the same principles of capital preservation in the short term (over rolling 12-month periods), coupled with a strong focus on risk management whereby we never take more risk than is required to deliver on the funds' stated return profiles.

### Meeting a variety of risk and return requirements



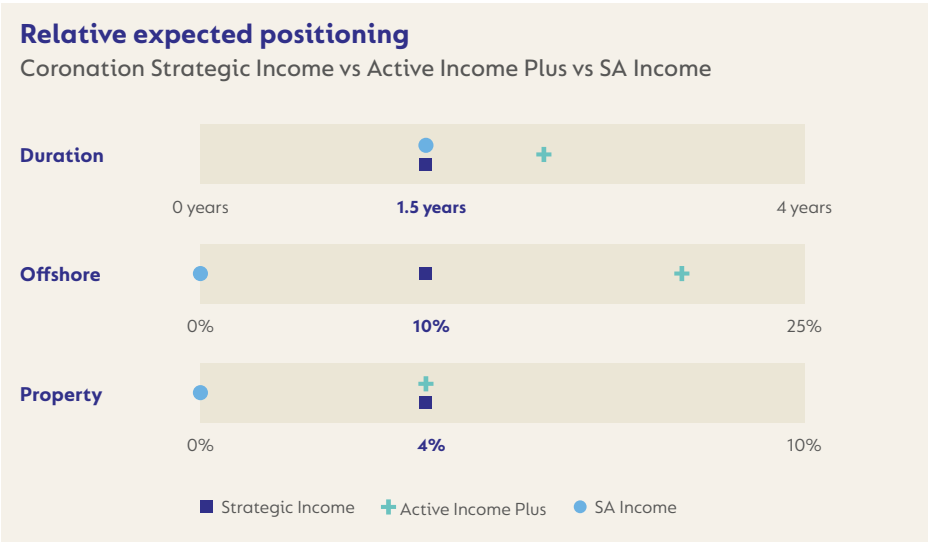
\* Launched 29 November 2023

\*\* Cash = Alexander Forbes 3-month (SteFI) Index

Source: Coronation



Relative to Coronation Strategic Income, the following visual demonstrates how the two newer funds are expected to differ in terms of duration and listed property as well as offshore exposure.



In turn, Coronation Global Strategic USD Income is expected to have an average duration that doesn't exceed three years, and listed property exposure of no more than 10%. The fund is suitable for investors seeking an intelligent alternative to US dollar bank deposits and wanting to utilise their offshore allowance in a conservative manner.

# How our income funds achieve their return profiles

We apply the following fundamental principles to deliver the stated risk and return objectives of our range of income funds:

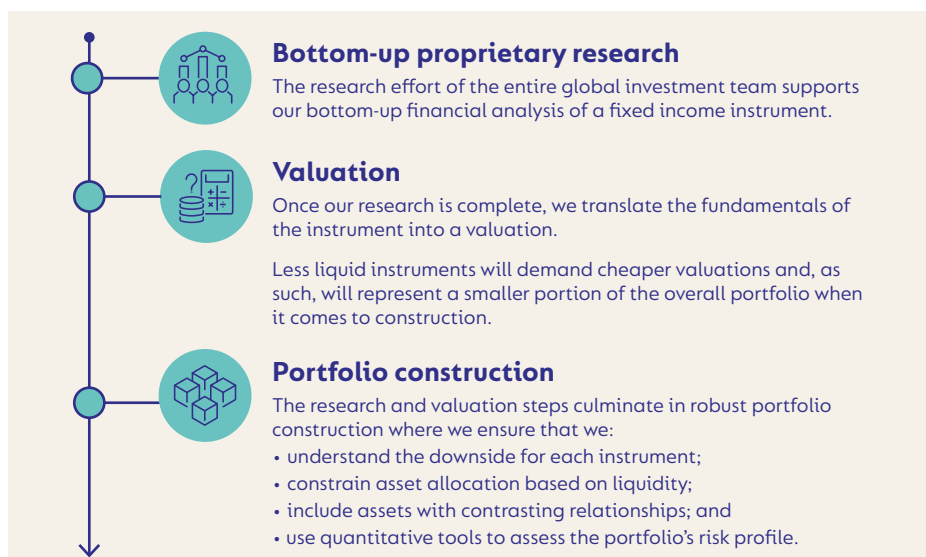
## 1. Robust portfolio construction

As with equities, we believe we can add value to conservative investors in our income funds through bottom-up security selection when assets are mispriced.

Our approach to asset allocation within the local and global fixed income universes mirrors that of the broader Coronation investment team, but the process needs to be overlaid with certain constraints given the needs of our income fund investors. These constraints include allocating to a blend of assets that:

- can deliver on our income funds' respective performance objectives;
- while prioritising capital preservation over 12 months; and
- providing liquidity to investors with immediate income needs (such as those drawing a regular retirement income).

The following visual demonstrates the process in a bit more detail:








## 2. Placing capital at risk

The reality is that in order to outperform cash over the long term, we need to take risk within our income portfolios. However, we never do this at the expense of our capital preservation commitment, or if it puts the fund at risk of underperforming cash (also see point 3). So we set out to put capital at risk according to the following guardrails:

### Taking considered interest rate (duration) and credit risk, where appropriate

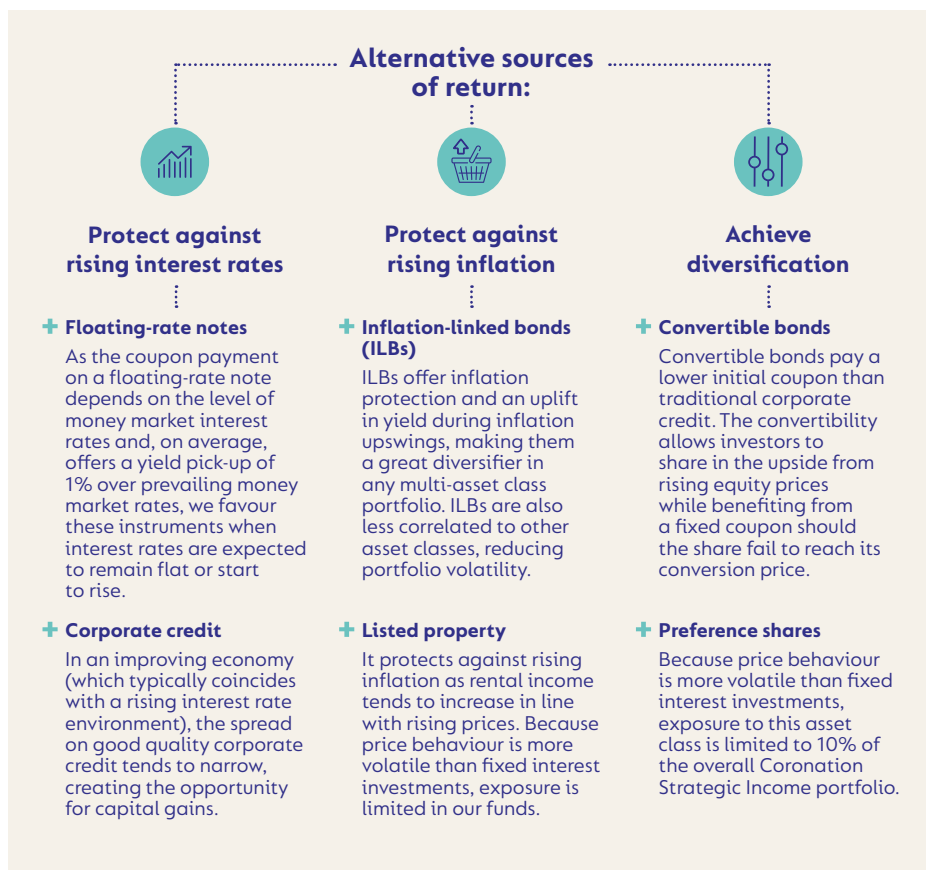
The following visual explains how we take considered interest rate and credit risk, where appropriate, across our income portfolios.

 Interest rate risk	 Credit risk
<p><b>Interest rate risk (duration) is the risk that arises for bond owners from fluctuating interest rates.</b> For example, when a bond's fixed rate is lower (i.e., less attractive) than the prevailing market interest rate, the market price of the bond decreases (i.e., the value of your asset declines). The longer the period to maturity for the bond in issue, the more significant the decline in its value in the secondary market.</p> <p>In turn, the market price of a bond will increase when its coupon rate is higher (i.e., more attractive) than prevailing market interest rates.</p>	<p><b>Credit risk arises for a lender when the borrower cannot return the capital at the stipulated time, or make the agreed-upon interest payments.</b> Credit risk associated with corporate bonds is higher than government bonds, as in a worst-case scenario, the government is assumed to be able to print money to make good on its obligations. Corporates therefore borrow at a higher rate than governments. The difference between corporate and government bond interest rates is called the 'credit spread'.</p>
<p><b>+ We consider all factors influencing the fixed interest investment cycle and actively manage the portfolios' overall interest rate risk to optimise the expected risk-adjusted return. In Coronation Strategic Income, duration is limited to less than two years. For Coronation Global Strategic Income, the average duration in the fund will typically not exceed three years.</b></p>	<p><b>+ We are highly cognisant of credit risk and only invest in corporate bonds when we believe that the yield compensates for the risk, or when there is a general rise in credit spreads. All credit decisions are subject to oversight by Coronation's independently chaired Credit Committee. We are typically more conservative in our credit risk management than many other funds in the domestic income category.</b></p>

## Actively managing our exposure to alternative sources of return when the likelihood of outperformance is high

To achieve our internal performance targets of cash plus 1.5%, 2% and 3% over the long term, one could argue that it is as simple as constructing a portfolio comprising only of instruments that offer yields in excess of cash.

However, allocating to alternative sources of return that offer protection and diversifying qualities requires careful analysis of the prevailing market environment followed by dynamically adjusting exposure when the likelihood of outperformance changes, as detailed in the visual below.





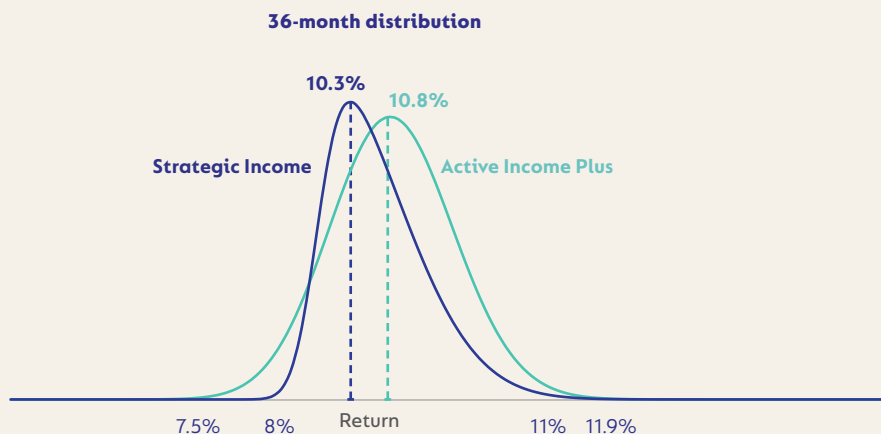
### 3. Avoiding excessive risk for certainty of return

As part of our disciplined portfolio construction process, we never aim to increase our income funds' risk profile or performance by increasing the possibility of investor downside.

This means that we won't attempt to deliver more than the stated return target if we believe it will put our capital preservation commitment at risk or if it will result in us underperforming cash (see chart below using our flagship classic income fund Coronation Strategic Income as an example). To achieve this, we use quantitative modelling to arrive at a blend of assets that allows us to meet our risk/return target with a high degree of certainty. As is also clear from the graph below, Coronation Active Income Plus is skewed more aggressively resulting in a wider range of outcomes.

#### Quantitative modelling allows us to meet risk/return targets with a high degree of certainty

Illustrative return distributions for Coronation Strategic Income and Coronation Active Income Plus



Strategic Income	
Mean return	10.3%
90 percentile range	8%–11%
Modified duration (incl. ILB)	1.67 years
Modified duration (excl. ILB)	1.51 years

Active Income Plus	
Mean return	10.8%
90 percentile range	7.5%–11.9%
Modified duration (incl. ILB)	2.16 years
Modified duration (excl. ILB)	1.95 years

Source: Coronation

# How our classic income funds delivered on their return profiles

## Don't expect a linear return series

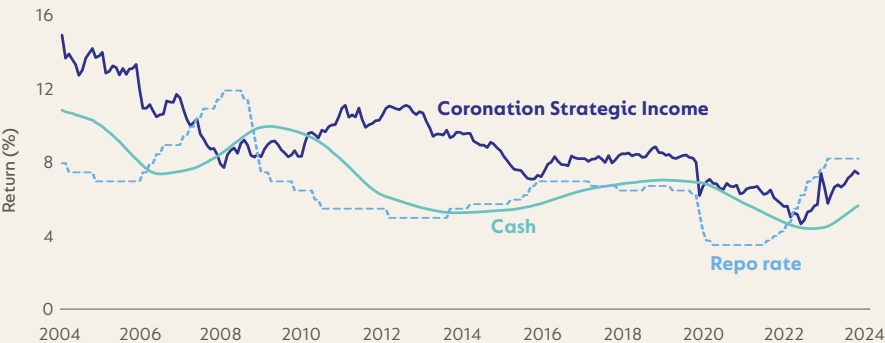
As explained before, the need to put capital at risk through the portfolio decisions means that our income funds will not have a linear return series like that of a money market fund.

Over short measurement periods, performance can fluctuate. However, we will never position our income fund portfolios towards a single outcome. Instead, we create portfolios that comprise a diversified set of assets and always take a conservative approach to risk (e.g., through option protection strategies).

Sometimes, in the short term, these funds cannot deliver on their cash plus targets. Rising interest rate environments make it more challenging to provide cash plus returns. When rates are falling, it becomes easier to achieve this goal. However, we are confident that we can consistently deliver on the funds' cash plus targets through the cycle.

## Consistently outperforming cash over more than two decades

Rolling three-year returns since inception\* of Coronation Strategic Income vs Cash



Average monthly returns since inception of Coronation Strategic Income\*

	When rates are rising	When rates are falling
Coronation Strategic Income	0.71%	0.81%
Cash	0.65%	0.54%

\* July 2001

Source: Coronation, as at end-February 2024



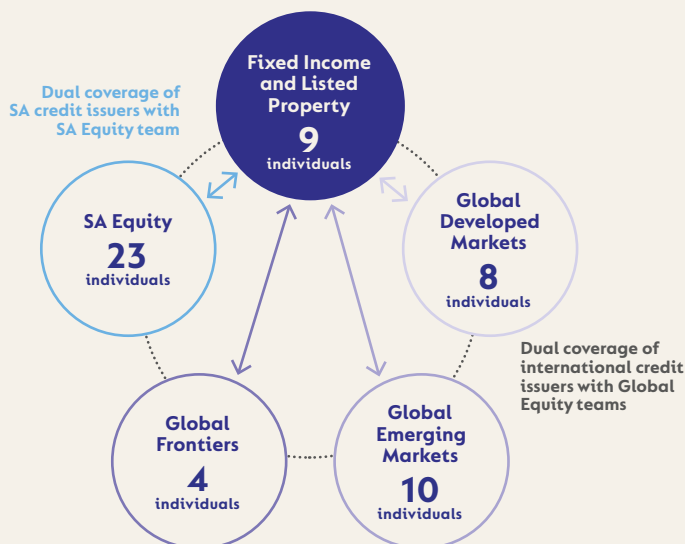
# A broad and deep team supporting these return profiles

## A competent team

Our fixed income team of nine specialists is well-resourced and fully integrated into our global investment team of 54 professionals (see below). These specialists provide vital inputs to extract maximum value across the potential return enhancers in the fixed income universe. The team covers instruments both locally and offshore. And to enhance the rigour of our investment process in this universe, we share dual coverage with our respective local and global equity teams of the local and international credit issuers held within our portfolios.

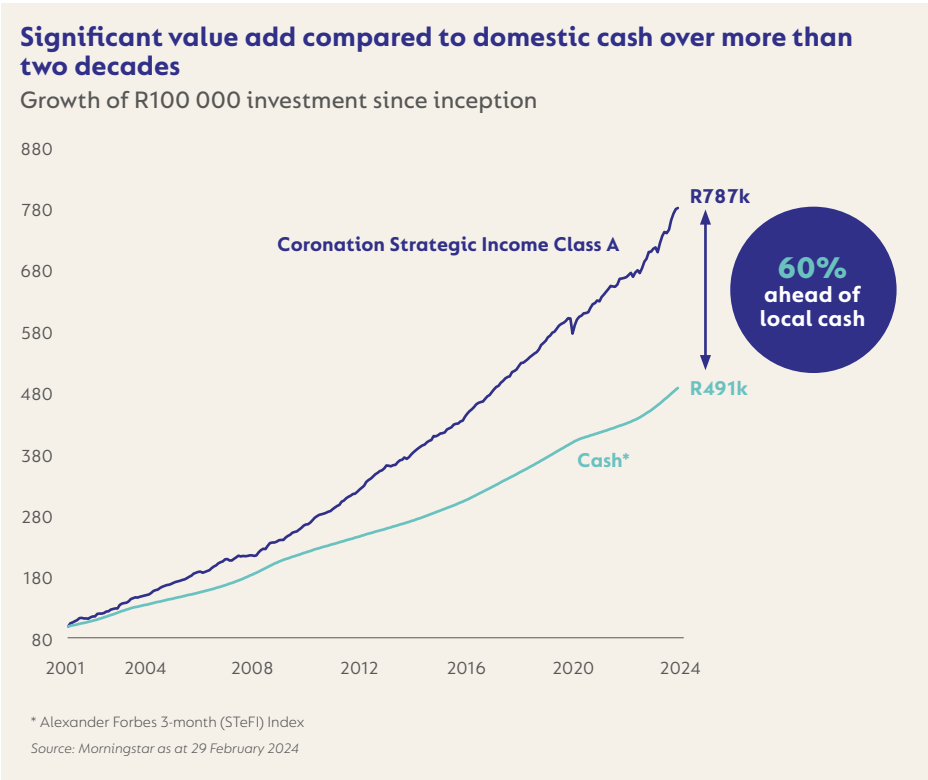
### 54 fully integrated investment professionals

Our fixed income team sits together with and works closely with our global and local equity investment colleagues to support us on local and offshore credit



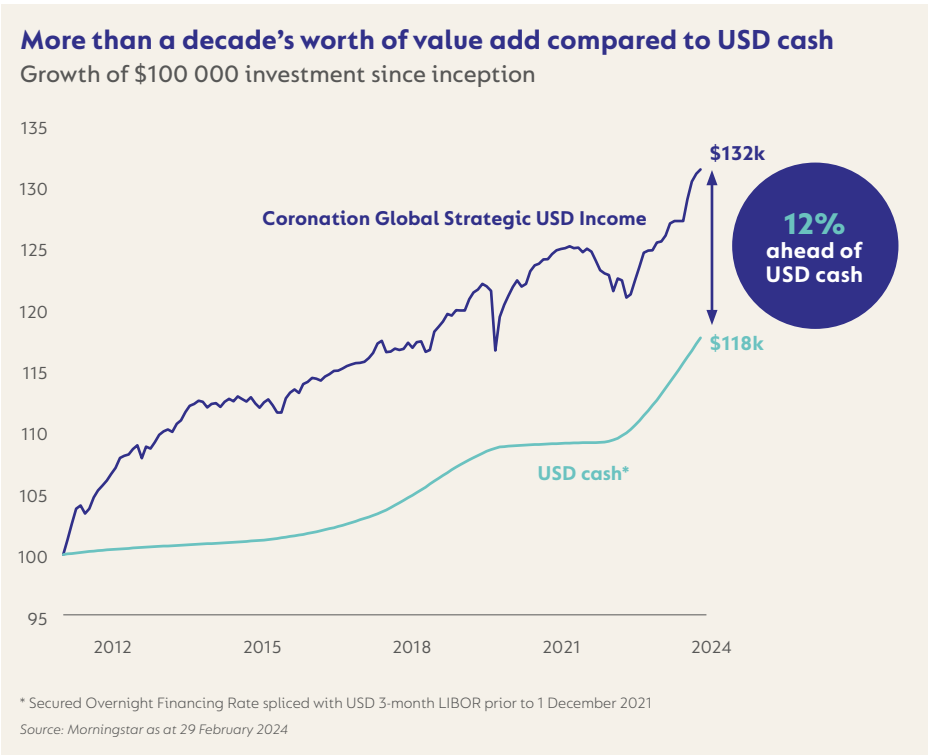
Expertise that culminates in desired outcomes for conservative investors, both locally and offshore

Our flagship domestic income fund, **Coronation Strategic Income**, consistently outperformed cash over its almost 23-year history, as shown in the graph below.





Equally, its global equivalent **Coronation Global Strategic USD Income**, produced returns ahead of US dollar cash over its almost 13-year track record.



# Conclusion

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This edition explained the complex nature of income investing and the challenges involved in choosing a fund that meets your needs from both a risk and return perspective.

To help investors in this regard, we made some improvements to our income fund range and demonstrated the fundamental principles we apply to our funds to arrive at their stated risk and return objectives. And as demonstrated in the long-term track records of our two flagship income funds, Coronation Strategic Income and Coronation Global Strategic USD Income, this approach has created significant value relative to local or US dollar cash, respectively, over multiple decades.





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Note that individual investor performance may differ as a result of the actual investment date, the date of reinvestment of distributions and dividend withholding tax, where applicable. Annualised performance figures represent the geometric average return earned by the fund over the given time period. Where foreign securities are included in a fund it may be exposed to macroeconomic, settlement, political, tax, reporting or illiquidity risk factors that may be different to similar investments in the South African markets. Fluctuations or movements in exchange rates may cause the value of underlying investments to go up or down. The Coronation Money Market fund is not a bank deposit account. The fund has a constant price, and the total return is made up of interest received and any gain or loss made on any particular instrument, in most cases the return will merely have the effect of increasing or decreasing the daily yield, but in the case of abnormal losses it can have the effect of reducing the capital value of the portfolio. Excessive withdrawals could place the fund under liquidity pressures, in such circumstances a process of ring-fencing of redemption instructions and managed pay-outs over time may be followed. A fund of funds invests in collective investment schemes that levy their own fees and charges, which could result in a higher fee structure for this fund. A feeder fund invests in a single fund of a collective investment scheme, which levies its own charges and could result in a higher fee structure for the feeder fund. Coronation Management Company (RF) (Pty) Ltd is a Collective Investment Schemes Manager approved by the Financial Sector Conduct Authority in terms of the Collective Investment Schemes Control Act. Unit trusts are traded at ruling prices set on every day trading. Forward pricing is used. For Domestic Unit Trust Funds and Tax Free Investments, including rand-denominated Offshore Unit Trust Funds, fund valuations take place at approximately 15h00 each business day, except at month end when the valuation is performed at approximately 17h00 (JSE market close). For these Funds, instructions must reach the Management Company before 14h00 (12h00 for the Money Market Fund) to ensure same day value. For Offshore Unit Trust Funds that are denominated in a foreign currency, fund valuations take place at approximately 17h00 each business day (Irish Time) and instructions must reach the Management Company before 12h00 (SA Time) to ensure the value of the next business day. For Retirement Products, fund valuations take place at approximately 15h00 each business day, except at month end when valuation is performed at approximately 17h00 (JSE market close). For these Products, instructions must reach the Management Company before 14h00 to ensure the value of the next business day. Additional information such as fund prices, brochures, application forms and a schedule of fund fees and charges is available on our website, [www.coronation.com](http://www.coronation.com). Coronation Fund Managers Limited is a Full member of the Association for Savings & Investment SA (ASISA). Coronation Asset Management (Pty) Ltd (FSP 548), Coronation Investment Management International (Pty) Ltd (FSP 45646) and Coronation Alternative Investment Managers (Pty) Ltd (FSP 49893) are authorised financial services providers. Coronation Life Assurance Company Limited is a licenced insurer under the Insurance Act, No.18 of 2017. 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