corospondent

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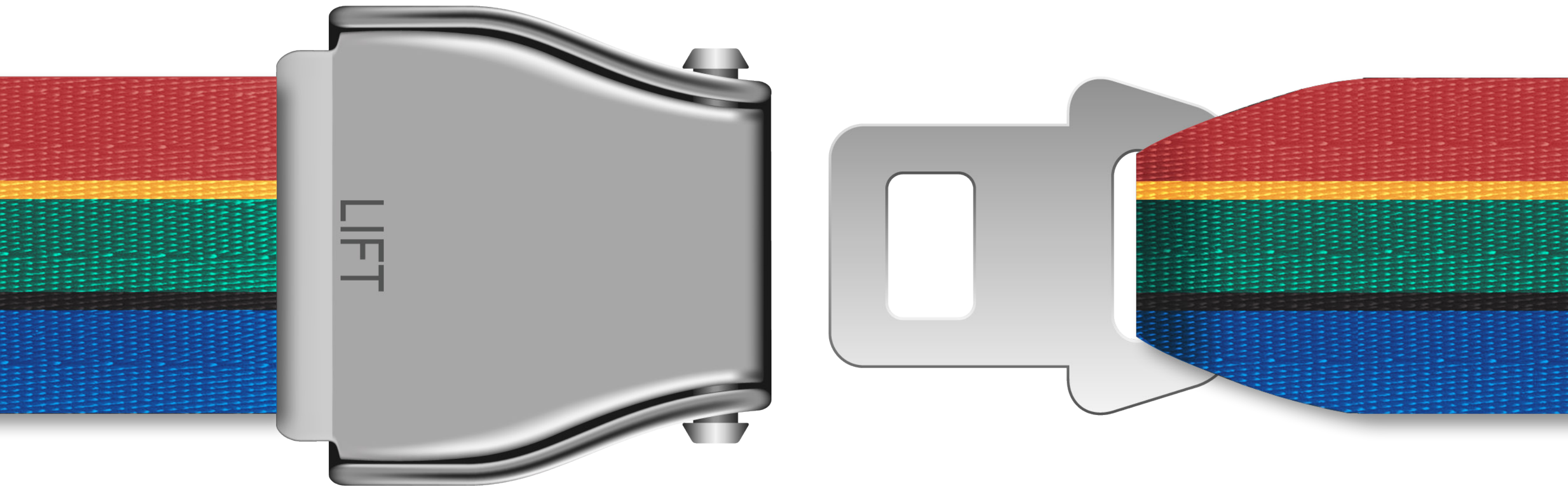

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NOTES FROM MY INBOX

AN AGE OF LIVING DANGEROUSLY

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.

It has been a period of profound political and economic change around the world. The shocking developments of 2016 continue to shift the ground under our feet. The new US president keeps on upsetting geopolitics, while the UK premier, Theresa May, recently triggered the famed Article 50, following the surprise outcome of the Brexit vote in June last year. So for the Brits it is, "See EU later!" – an apt headline from *The Sun* newspaper.

Throughout the world, the vox populi is growing louder and louder, with people everywhere expressing a universal discontent with the established world order. People are simply fed up with being left behind, which they blame on globalisation. Understandably, they want to see economic prosperity that does not only benefit a few. However, their discontent is channelled towards solutions (protectionism, anti-immigration, nationalism) that will not necessarily serve their own interests, or those of the broader society, in the long run. This will have a concerning impact on the direction that economic vectors are pointing.

In South Africa, the last few weeks have felt surreal (and not in a good way). South Africans too are currently living through extraordinary times of political and economic crisis. The midnight hour cabinet reshuffle at the end of March has triggered a shockwave of ratings downgrades, the effects of which will be felt for years to come. The country lost its investment grade rating, which was secured through great discipline 17 years ago. This achievement by the first democratically elected government has had a tremendously positive impact on the South African economy.

Political events have most likely delivered a 'knockout blow' to the nascent economic recovery South Africans had been optimistically hoping for. The situation has the most serious consequences for the poor who have no defence against the economic fallout unleashed by infighting in the ruling party. A culture of corruption and patronage is truly ripping South Africa apart.

Against a turbulent background, this bumper edition of *Corospondent* contains our analysis of the many (concerning) events unfolding around the world. In the lead article (page 5), Neville Chester dissects the impact of the recent events on South Africa and the aftershocks that await investors and the economy.

It is in turbulent times like these that we are continually reminded that risk is an integral and unavoidable part of life. And the first rule of investing is to ensure that you allocate capital to those opportunities that will appropriately reward you for the risk you have taken. Most of us like to just talk return: it's simple and, let's face it, easier to understand. In his article (page 11), our CIO, Karl Leinberger, takes a closer look at the vital role that risk management plays in investments. I found it a very timely read for this new era of uncertainty.

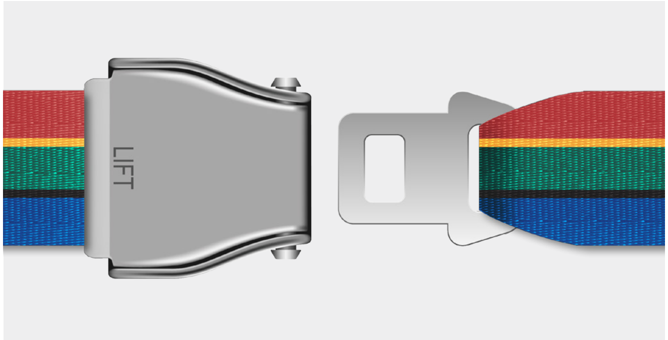
The rise of populism is a significant force around the world. Our economist, Marie Antelme, examines the causes and economic ramifications of this strong political doctrine of our time (on page 8).

Times of stress and great emotion in markets often present great investment opportunities, and as always we continue to invest in long-term holdings that we believe will unlock value for our clients. In this issue, you will find our views on opportunities in frontier markets (page 20), in a Russian banking behemoth (page 16) and in the mobile telecommunication group MTN (page 18).

History has taught us, time and time again, that our ability to forecast the immediate future is limited. Our focus remains on building diversified portfolios of undervalued assets that can withstand the shocks that seem to keep coming our way. We have been steadfast in our focus and commitment to deliver investment excellence for our clients.

Usually, at this point, I would urge you to enjoy the read. In truth, I cannot guarantee you a pleasant reading experience this time around. But I do hope that you find our insights useful, providing you with some security and clarity in these pressured times.

Kirshni



SOUTH AFRICA IN CRISIS

RADICAL ECONOMIC TRANSFORMATION WILL NOT END WELL FOR THE MAJORITY OF SOUTH AFRICANS

by Neville Chester

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.

During our recent institutional roadshow, I was, for the first time in many years, fairly upbeat about South Africa's prospects for the year ahead. Commodity prices were up, heavy rains had resoundingly broken the drought, and both consumer and manufacturer confidence indices were rising. All of these boded well for a pick-up in economic growth. With the rand having strengthened, and inflation firmly under control and heading well below the top of the inflation target of 6%, the prospects were looking good for interest rate cuts that would further boost consumer spending power and the economy in general.

Post a recent investment conference hosted in March, where international investors met a broad array of South African companies, it was clear that this confidence was shared: share prices of most South African-specific companies rose as international investors started backing the recovery with investment into the country. The rand strengthened further and bond yields dropped to a remarkable 8.2%; remarkable, as generally global bond yields were rising, not falling. All indications were that South Africa was pulling itself back on track post the shake-up in December 2015 when markets were shocked by Nenegate – the firing of finance minister Nhlanhla Nene and his replacement with little-known backbencher Desmond van Rooyen.

With this improved confidence would come stronger economic growth, which drives investment, which in turn would bring with it jobs and improving financial results, which then would boost overall tax revenues.

The African National Congress's (ANC) elective conference in December 2017 was the main risk to this improved outlook, with a clear high road/low road scenario depending on which faction within the ANC would come out on top. By mid-March, it still seemed that either faction had equal odds of winning the elective conference and setting ANC policy for the next five years.

All of this was completely derailed on Thursday 30 March. In a surreal event, a midnight cabinet reshuffle was orchestrated, apparently without involving any of the senior members of the ANC national executive committee. The ANC secretary general was so shocked as to publicly state, "This reshuffle was not done in consultation with the ANC, we were given a list that was done elsewhere and then it was given to us"[1]. Ten ministers and ten deputy ministers were fired or moved to different portfolios, and a number of new members, many of whom are fairly unknown, were introduced. The main blow to the economy was the removal of both the finance minister and his deputy, despite their sterling job in staving off a ratings downgrade and delivering a properly funded budget, notwithstanding the economic challenges South Africa faced in the past year. They were replaced with Malusi Gigaba, previously minister of public enterprises and more recently home affairs, and Sfiso Buthelezi, a relatively unknown backbencher who was an advisor to Zuma prior to his rise to the presidency. Interestingly, two of the new appointees, Gigaba and the new minister of police, Fikile Mbalula, were both past presidents of the ANC Youth League (ANCYL).

There has been much speculation as to where the new names came from, and what the intentions of all these various ministers will be. One can read plenty about their past connections and foibles in the popular press. It is more important to deal with the factual results of these appointments and what the economic impact will be. Perhaps most telling is the response of the current president of the ANCYL to ratings downgrades following these announcements: "We are welcoming the junk status. When the economy rises again, it will be held by us." The move to junk is nothing to be welcomed, and expectations of a rising economy an example of naivety in the extreme.

THE REAL EFFECTS

Since the cabinet changes, the yield on the benchmark 10-year government bond has pushed up to 9% and the rand has fallen from its recent peak of R12.20 to the dollar to R13.80. Domestic interest rate-sensitive companies like banks and retailers have fallen by 10% to 15%.

[1] *Business Day 31 March 2017*

Expectations of rate cuts and a return to economic growth are disappearing and inflation is no longer going to ease as expected. Why is this the case?

Regardless of all the conspiracy theories doing the rounds about looming special deals for connected parties, we know that the president and new ministers are now talking about radical economic transformation. These are the kinds of words and policies used by politicians with falling ratings to try to drum up support from the electorate. While it might succeed in appeasing the electorate, the only transformation to the economy is going to be a deterioration, ultimately impacting those self-same voters the most. Slicing up a pie in different ways does not grow the pie, but is certain to cause it to shrink.

State-owned enterprises (SOEs), which have been mismanaged and have consumed billions of rands over the past decade, are likely to be topped up by a newly compliant Treasury. This alone will increase the government debt burden by billions of rands. Ratings agencies have been very wary of these institutions, given their potential to massively increase the debt burden of all South Africans. Over and above all of this, the mooted project to build six to eight nuclear reactors, with a projected cost exceeding R1 trillion, appears to be on track again. Under Gordhan, the National Treasury had been steadfastly blocking this project as unnecessary and unaffordable. Post his removal, Treasury is now supportive of it progressing, despite the fact that following demand-side measures and the two new coal-fired power stations coming on line, South Africa now has significant surplus power capacity. South Africa has gross debt to GDP levels of 51% (rising to 61% if guarantees issued to SOEs are included). If all existing SOE debt is included, it rises to 69%, and with a potential R1 trillion nuclear build, debt to GDP exceeds 90%. Should this happen, the country would be in a debt trap death spiral.

The reaction of two of the global ratings agencies to these changes has been swift and brutal. South Africa's foreign debt ratings have been slashed to subinvestment grade (junk), with immediate impact on the cost of the country's funding. This is not something only affecting the arcane world of finance, but also has real punitive effects on every South African. As the cost of funding South Africa's debt goes up, it takes away valuable resources that could be used to fund social services, healthcare and education. It also results in a decline in the value of existing South African bonds, impacting millions of pensioners. We expect the remaining ratings agency (Moody's) to cut the country's foreign debt rating in the next few months. Meanwhile, South African debt has already been ejected from the JP Morgan Investment Grade Index. The biggest risk is still outstanding, however. Only one of the ratings agencies (Fitch) has moved South Africa's local currency debt rating to junk. Should another ratings agency cut this rating to junk, the country will be ejected from the Barclays Global Aggregate Bond Index, resulting in the forced sale of approximately $5 billion of South African bonds. Should Moody's and Standard & Poor's downgrade our local currency bonds to junk status, we will be ejected from the Citi World Government Bond Index, triggering the forced sale of some $9 billion of South African bonds. (At current exchange rates, this represents a cumulative outflow of R193 billion from the South African bond market.)

Do not hold your breath for any BRICS-friendly ratings agency to make an iota of a difference. As Warren Buffett famously said, never ask a barber whether you need a haircut. Similarly, global investors will not be swayed by the biased views of such an agency.

After Gordhan was reappointed as finance minister following the shock of Nenegate, corporate South Africa rallied around the National Treasury to deliver work streams to prevent a ratings downgrade and to drive economic growth through targeted investments in small businesses and various programmes designed to assist in alleviating service delivery and poverty. By and large, these initiatives were successful, certainly in managing the ratings agencies and in the establishment of a R1 billion fund to support SME development. Without a doubt these initiatives were instrumental in staving off the downgrade. As the Treasury shifts its focus to providing more funding to SOEs, including the unaffordable nuclear build, and amid its stated support for radical economic transformation, these initiatives are likely to stagnate and ultimately will be undone.

Given that the foreseeable outcomes of the radical cabinet changes, pushed through against the wishes of many senior ANC members, are all negative, why has the market reaction not been as negative as when Nene was fired? It is not obvious, but a couple of possibilities exist. Firstly, the sell-off after Nenegate proved a great buying opportunity as the market swung from despair to hope when Gordhan took control of the Treasury. Bonds and South African shares, which were hardest hit, generated some of the best returns in 2016 as the market started to believe in the South African economic recovery story. There is definitely an element of hope playing out in markets currently where investors are buying these same assets in the hope that fiscal discipline is not going to be lost.

Secondly, as mentioned, the first quarter of 2017 was showing promising signs of recovery and many international investors were encouraged by a nascent economic turnaround. These investors may be viewing this sell-off as an opportunity to invest, not realising the significance of the change in South Africa's fiscal trajectory. All the major political surprises globally in 2016 have generally been buying opportunities, with UK and US equity markets rallying hard after their own political shocks. While South Africans are aware of how significant a blocking role the National Treasury and the incumbent finance minister had in the South African government, this is not common knowledge elsewhere.

Finally, one can only assume it is the ‘frog in the pot’ syndrome. According to the classic analogy, a frog thrown into a pot of boiling water will jump out in fright, saving itself, but if you put it in a pot of cold water and slowly turn up the heat, it will eventually die, not noticing the more subtle change in temperature until it is too late. Having been through a similar event before and having heard constant threats of Gordhan’s removal – have we all just become complacent to what is now, hot water?

One cannot overstate just how significant the change at the National Treasury is for South Africa. Since the dawn of democracy in the country, it has been a steadying force, applying fiscal conservatism as a guard against wasteful and profligate spending. The Public Finance Management Act is an important piece of legislation that required the finance ministry to have a final say in all major projects approved by other departments. Investors and all South Africans relied on the prudent actions of a well-respected finance team to control expenditure across government. If you look at countries around the world where radical government changes (led by populist parties with no fiscal restraint) have played out, the end game has been pretty predictable. Rampant growth in debt was followed by rampant printing of money and, ultimately, currency crises and defaults. While Zimbabwe is the obvious example, we have seen the same across many Latin American countries like Venezuela, Bolivia and Argentina. This is playing with fire, and it does not end well for the economy and the people.

PORTFOLIO IMPLICATIONS

We have for some time been managing our strategies with a high allocation to offshore assets. Most of our asset allocation strategies with mandates to invest offshore are at their maximum regulatory or mandated levels. Within our South African equity allocation we have more recently had a high weighting to companies with earnings outside of South Africa or driven by dollar-based revenue lines (such as mining stocks).

In early 2016, we bought a lot of South African shares as their prices fell in excess of 30% post Nenegate. As the year progressed and these shares did well and the rand strengthened, we felt that the return opportunity was once again more favourable, outside of the purely South African shares. Given that the moves following the recent cabinet shake-up have not been as extreme, and the fact that we think the long-term changes in fiscal strategy are far less benign, we are not inclined to increase our purely South African weighting.

Bonds, both globally and in South Africa, have not looked attractive on a risk-return basis since the global financial crisis. We have avoided global bonds and, other than some tactical buying post Nenegate, we have generally avoided South African bonds as well, due to our assessment that the yields did not offer sufficient return for the risk involved. We have preferred property instead where yields were as attractive, and well-managed companies are able to grow distributions in line or ahead of inflation. We have not been tempted to buy South African bonds as yet given our concerns over the likelihood of our debt burden rising significantly and necessitating further debt issuance outside of the long-term projections of the budget office.

Our funds have performed well in volatile times, and the first quarter of 2017 has not been different. We have built portfolios based on a careful assessment of maximising returns at an acceptable level of risk. Still, this is cold comfort for the millions of South Africans facing a much bleaker future today as result of a stagnating economy and the reduced resources available for meeting social services. ■

FUELLED BY FEAR

THE RISE IN POPULISM AND ITS ECONOMIC IMPACT

By Marie Antelme

Marie is an economist within the fixed interest investment unit. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

Brexit, the recent election of Donald Trump as US president and the upsurge in Eurosceptic parties over recent years are widely deemed indicative of a rise in 'populism'. This umbrella term is hard to define: the representation of a populist political 'left' and the policies it is likely to implement will be different from a populist 'right'. Another challenge is distinguishing between politics that may give rise to dangerous isolationist and divisive policies, and a more moderate representation of the interests of vulnerable groups. Using the term carelessly risks ignoring some of the nastier characteristics that have accompanied truly populist politics in the past. More often than not, political parties representing minority interests – the economically excluded or downtrodden, and a range of interests in-between – are labelled populist when this may not necessarily be the case.

WHAT IS POPULISM?

We have all read headlines in the past months about the politics of anger, but beneath the anger is always fear. Having established that there is no single definition of populism, and no common ideology that defines populist politics, it helps to distinguish between the ends of the spectrum and identify a number of common traits.

In today's language, 'leftist' political populism would likely see lower- and middle-income voters stand against a wealthy, politically powerful and economically influential elite – movements akin to the labour movements of the past. 'Rightist' populism is more likely to see the same groups uniting against an elite accused of protecting or supporting outsiders – movements characterised by anti-immigrant, racially resentful politics. This is an 'us and them' kind of politics, which holds the politically influential elite to ransom for a range of grievances, with a particular focus on foreigners or minorities. In both cases, the people most likely to vote for a populist party or candidate tend to be economically vulnerable – those who are older, have experienced job losses or income stagnation, or feel they face a threat to their social or national identity, survival, livelihood or personal wellbeing.

There are other shared characteristics, aside from a broad division of the population into 'the people' and 'the elites'. Populist movements tend to show fierce antagonism towards intellectuals (today's 'liberal elite'), favouring instinct over education. They champion polarising, divisive views and generally display contempt for the judiciary, and possibly also for the military and other political powers (such as government intelligence). Protectionist trade policies tend to feature, along with a willingness to implement capital controls and nationalise assets. There is usually also a strong intolerance of a free press.

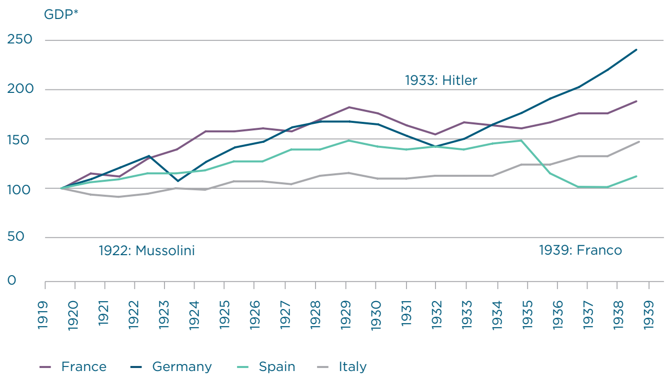
POLITICS WITH A LIVELY PAST

Populist 'uprisings' are not uncommon – especially in the US. During the late 19th century, the farmers and labourers who constituted the People's Party in the US (also known as the Populist Party, or simply The Populists) united against capitalist interests perceived to be driving inequality. The party called for the nationalisation of essential economic infrastructure – notably the railways – and was very critical of private banking.

Over time, the People's Party joined other labour movements, and in 1896 endorsed a Democratic candidate, who swept to victory through the People's Party's constituencies. Having lost its independent identity with this endorsement, the party never really recovered. However, a number of US presidents who have followed have favoured 'populist' policies as part of their election platform – most recently (and visibly) president Trump.

By the early 20th century, a new wave of populism emerged in Europe, which became more intense during the mid-war period, undoubtedly fuelled by the economics of post-World War I Europe, the Great Depression and the trade wars that coincided at the time. The political climate was characterised by nationalism in France and Francisco Franco's Spain, fascism in Italy and Nazism in Germany, especially between the two world wars as 'rightist' populism fuelled the rise of the National Socialist German Workers' Party under Adolf Hitler.

EUROPE: GDP BETWEEN THE WORLD WARS



*1919 = 100

Source: New Maddison Project Database

THE MODERN HISTORY

After World War II, populism faded with the careful, deliberate integration of social and political policies by Western governments of the time. In fact, the past 40 years or so have been an anomaly, with very little populist political activity globally (outside of Latin America) and almost no populist activity in developed economies.

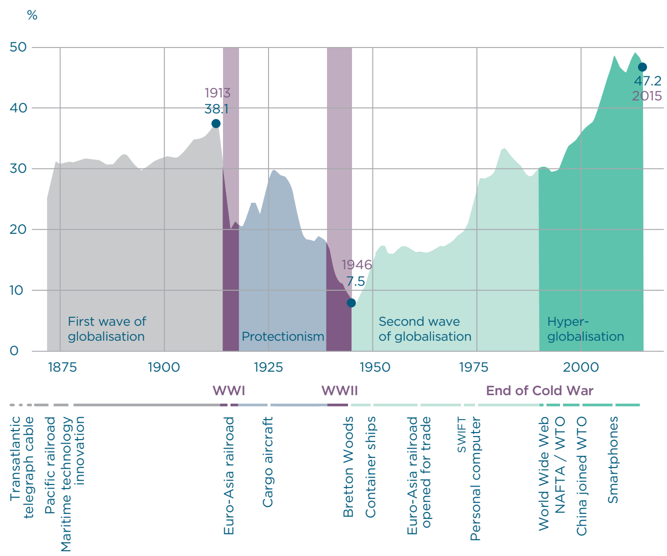
Most notably, in the aftermath of World War II, the US, UK and European governments consciously implemented a strategy to ensure that economic development was strong and integrated enough to prevent such a war from ever happening again. For these countries, this meant that domestic policy initially focused on creating jobs and getting people employed. The success of this combined effort was the 'golden era' of growth in the 1950s and 1960s, when employment (primarily through union jobs in manufacturing) ensured rising wages, healthy gains in output and advancements in technology. But the economics were not all good: full employment led to rising wages, which fuelled inflation.

During this time, foreign policy – especially trade policy – actively promoted more open, integrated systems. Globalisation re-accelerated after the war, with the Bretton Woods agreement committing 44 countries to an integrated, gold-linked currency system that facilitated trade convertibility and established the US dollar as a reserve currency. The International Monetary Fund (IMF) and the World Bank were established in 1945; the IMF to monitor foreign exchange movements and facilitate reserve lending (trade), and the World Bank to aid war-torn countries' rehabilitation. Technological advancement helped the world become more accessible, as container ships improved the speed and cost at which goods could be moved. In an effort to form the International Trade Organisation (the precursor of the World Trade Organisation), 23 nations signed a General Agreement on Tariffs and Trade in 1947.

These programmes were initially very successful. However, by the mid-1970s, high inflation led to somewhat of a revolt by the creditors within Western economies – the investors, banks and wealthier households. With the election of Margaret Thatcher as British prime minister in 1979 and Ronald Reagan as US president in 1980, there came a shift in economic policy focus – both leaders actively pursued policies to lower inflation and break trade unionism, benefiting the wealthy more than the indebted workers. ("Low-priced Asian manufacturers cost less. Unions are bad!")

GLOBALISATION CYCLES THROUGH HISTORY

Trade openness*



* Calculated as exports + imports as a % of GDP for 17 economies, aggregated using GDP-PPP weights. 3-year moving average.

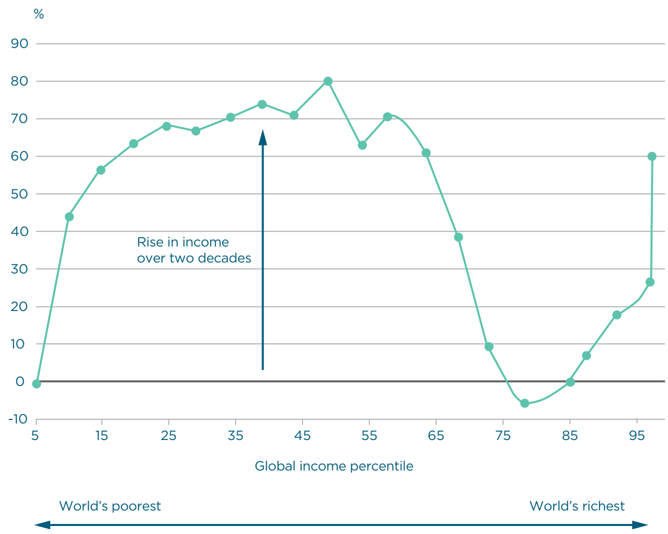
Sources: Barclays, National Bureau of Economic Research macrohistory database

Since the late 1970s, economic policy in developed Western economies has been dominated by a move to inflation-fighting monetary policy, a prolonged trend of falling interest rates and the disintegration of trade union movements. Globalisation also picked up pace, with Asia opening to trade and a visible acceleration in trade agreements. Overall, the period was very good for 'creditors' but bad for households with debt, mostly in the middle classes. The process has also been reinforcing: as 'creditors' have benefited, their political preferences have been reflected in the elected leaders of most Western countries.

This has left many voters disenfranchised. A well-known study by economist Branko Milanovic introduced the so-called 'Elephant Chart', an insightful snapshot of the impact this process has had on global incomes. Between 1988 and 2008, the combination of lower inflation (and interest rates) and trade openness led to an increase in real incomes for almost everyone in the world ... except the middle classes of the West. For these people – many of whom are male, middle-income earners and perhaps less educated in the post-war industrial era – income remained almost unchanged for 30 years.

The acceleration in credit growth from the early 2000s enabled these households to live beyond their stagnant means and to accumulate wealth as housing and other asset prices boomed. The market crash in 2009 – and in particular, the housing market collapse and spike in unemployment in the US and, to a lesser degree, the UK – was devastating. Despite the best efforts of economic policy, income was lost. So too were wealth and social identity, while fear crept in.

CHANGE IN REAL INCOME BETWEEN 1988 AND 2008



Source: Global Inequality: A New Approach for the Age of Globalisation, *Branko Milanovic*

While covering the history behind the rise in modern populist politics across a broad spectrum, it bears remembering that the circumstances affecting individual countries differ. So too do the issues that are fuelling current voter unhappiness. In the US, Trump's standpoint is somewhat of a mixture of populist policies, as he takes his cue from both the 'leftist' Rust Belt and 'rightist' anti-Mexican/anti-Chinese sentiment. In the UK, France and the Netherlands, lost wealth, stagnant incomes, immigration and the oppressive weight of governmental fiscal burdens – especially in the EU, where economic health differs so widely by country – are all aggravating factors.

In South Africa, the turning political tide bears worrying characteristics of other populist regimes, which are all increasingly visible: the antagonism towards intellectuals, xenophobia, challenges to a free press, interference with institutions and the judiciary, a rejection of conservative Western economic policies, demands to capture or nationalise private assets and an 'us' versus 'them' rhetoric.

WHAT IS NEXT?

History has not judged populist governments kindly – and with good reason. In many cases, populist policies were initially successful: growth accelerated and government spending fuelled investment. But excesses were hard to fund and reign in. Skyrocketing inflation and currency collapse have tended to be the catalysts for populist regimes' downfalls, but the rehabilitation of fiscal and external accounts, and the rebuilding of institutions, take time – and come at great economic cost.

The experience of countries such as Chile in the 1970s and Peru in the 1980s is instructive. Both countries had experienced a period of economic hardship. The promise of radical economic change to an impoverished electorate saw the election of (two different kinds of) populist candidates in Salvador Allende in Chile and Alan García in Peru. Economic reform achieved under IMF programmes, limited as it was, created sufficient economic headroom for both leaders to implement highly expansionary economic agendas focused on the redistribution of income and the restructuring of the economy. In both cases, conservative policies were actively rejected. Among the economic justifications was a consensus that fiscal risk was exaggerated, or even unfounded. Although successful at first – employment and wages rose, inflation moderated and economic growth accelerated – bottlenecks ultimately emerged as domestic demand expanded rapidly, and import demand with it, putting pressure on reserves. Inflation, exchange controls and deteriorating fiscal balances led to shortages over time, and ultimately, to unstable politics and economic collapse.

South Africa may well be at risk of repeating some of these mistakes. Certainly, recent changes in key policymakers and the reiteration of the ruling party's commitment to 'radical economic transformation' echoes the party mandates of Chile and Peru to a degree. How this commitment translates into policy changes and a new economic agenda remains to be seen, but any large-scale utilisation of state funds on unaffordable infrastructure may well precipitate an increasingly unsustainable fiscal (and external) position.

Globally, the biggest challenge for the world today is not the immediate economic impact of Brexit, or the future of the US under a Trump administration. Rather, it is the realisation that the neoliberal order that has dominated economic and political policy agendas over the past 70 years is at best under threat, and at worst breaking down. In some cases, policy reviews may not be a bad thing.

Countries with ageing populations (like the US and many European countries) need a pragmatic, agreed policy on immigration. In Europe, failure to agree on fiscal and banking integration has hamstrung the finely crafted union. In the UK, discontent over service delivery, economic stagnation and liberal immigration policies require all these issues to be re-examined. More broadly, the failure of economies to grow inclusively after the global financial crisis might necessitate a review of crisis-related legislation.

Importantly, the demands of populist electorates in the US, Brexiteers in the UK and Eurosceptics across Europe need to be considered and addressed by mainstream parties. The problem is that these parties may find it difficult to address the institutional and economic issues that have fuelled the rise in populism in the first place. Finding the right kind of jobs – with sufficient pay – in a world of integrated supply chains and disruptive technologies, while providing effective social support as populations age, sounds impossible. But failure to do so will further threaten moderate political legitimacy.

Arguably, Europe is in the most challenging position here. Both the US and UK have political and economic levers to pull, which Europe does not. It is easier for the US and the UK to replace their leadership within an election cycle, should economic outcomes disappoint. This may result in a more moderate (but still protectionist), nationalistic approach to domestic policies than we have seen. It will not fix the problem, but it could ultimately affect the process. In Europe, the reform process – in fact, almost any process – is hampered by unequal economies, and the disintermediation of politics and fiscal policy.

Unless there is an adequate response by moderate governments, macroeconomic performance improves and the fear that is fuelled by loss of income abates, the populists will continue to gain ground. While the initial response of markets and even economies may be positive, history suggests that poorly coordinated policies in a multipolar world are not good for growth, and may have severe unintended consequences. ■

RISK

THE NUMBER YOU NEVER SEE

By Karl Leinberger

Karl was appointed CIO in 2008. He joined Coronation in 2000 as an equity analyst and was made head of research in 2005. He manages the Coronation Houseview portfolios.

"Competition can be pretty intense when your competitors play like they can never get hurt." – Seth Klarman

"Our predictors may be good at predicting the ordinary, but not the irregular, and this is where they ultimately fail … What matters is not how often you are right but how large your cumulative errors are. And these cumulative errors depend largely on the big surprises, the big opportunities." – Nassim Taleb

The primary objective in investing is to deliver the best risk-adjusted returns possible. Since return and risk are two sides of the same coin, an interrogation of one without a full understanding of the other is meaningless (and dangerous).

Return is, of course, the easy one. We all know what returns any given security, portfolio or fund manager has delivered in the past. Although future returns are a guess (albeit an educated one), historic returns are fact.

Risk is another story. Winston Churchill once described Russia as a riddle, wrapped in a mystery, inside an enigma. He could so easily have been speaking on the topic of risk. I say this because:

- Opinions differ on what risk is.
- Measuring it presents some challenges.
- In contrast to return, risk remains an opinion as much after the event (ex-post) as it was before (ex-ante).

WHAT IS RISK?

In financial theory, risk is typically defined as volatility. It is this axiomatic assumption we have to thank for the plethora of betas, Sharpe/Sortino ratios and tracking errors we have in our industry. At Coronation, we disagree. We define risk as the possibility of permanently losing capital. Warren Buffett has this to say on the distinction: "… now if the stock had declined even further to a price that made the valuation $40 million instead of $80 million, then its beta would have been greater. And to people that think beta measures risk, the cheaper price would have made it look riskier. This is truly *Alice in Wonderland*. I have never been able to figure out why it's riskier to buy $400 million worth of properties for $40 million than $80 million."

The irony is that risk (of losing money) is often highest at times when volatility is low and complacency abounds. A Minsky moment refers to the risks that often bubble under the surface in extended periods of prosperity. In this environment, asset values typically rise. This often leads to increased confidence, which then fuels speculation and increased levels of leverage. Good recent examples of this include the US housing bubble and the commodity bubble in the mid-noughties. On both occasions volatility was at historically low levels at a time of great risk (of losing money) to investors.

The conventional definition of risk implies that a portfolio full of cash has high active risk and the likelihood of a high tracking error. We would counter that the risk of the investor losing his/her money is low.

I should qualify my comments by saying that I think that volatility does have some informational value. I even think that it gives some indication of the riskiness of a security or a portfolio. But I do not think it is a proxy for risk, and I certainly do not think that volatility equals risk. I think the reason the investment industry picked the volatility definition of risk is its lack of ambiguity. Seth Klarman, head of Boston-based hedge fund Baupost Group, recently said, "Wall Street is a place that highly confident people go to work". He could have added 'highly numerate' to that description.

Our industry is full of highly numerate people – and for the person with a hammer, every problem looks like a nail. Volatility is a number that is easy to understand and easy to observe. It does not enter the murky realm of opinion (which the alternative definition does). Volatility is a hard fact, and I think that is why our industry backs it.

HOW CAN ONE MEASURE RISK?

The bad news is, I do not think one can.

Fortunately, as American baseball legend Yogi Berra said, you can observe a lot just by watching:

- **Returns over the very long term.** Although returns achieved over a short assessment period reveal little, inadequate risk management should be exposed over long periods. The bad news is that I think the required assessment period is beyond the patience of most observers. (I am thinking here of at least 10 years.)

- **Inflection points in major cycles.** As Buffett so famously said, it is only when the tide goes out that you see who was swimming naked. For example, high exposure to US financials or commodity stocks in the mid- to late-noughties looked prescient at the time, but was subsequently exposed as momentum investing when the cycle turned – with little regard for the risk of losing clients' their money, permanently.

WHY IS IT IMPORTANT THAT RISK IS AN OPINION AND NOT A FACT?

Sometimes, explanations can be more helpful than definitions. My favourite explanation of risk is Elroy Dimson's: "More things can happen than will happen."

Human beings are consummate storytellers. Even in an impartial telling of history, we tend to give too little recognition to the fact that while events played out in one way, they could so easily have played out in another. Nothing ruins a good story more than the spoilsport who dwells too long on an inconvenient nuance or the role that happenstance played in the final result. How different would the world we live in be had Adolf Hitler or Mao Zedong not been born, or had the Bolsheviks not prevailed in what was a fragmented and disorganised Russian revolution?

Although our brains are wired to think that the passing of time reveals all, we need to keep reminding ourselves that it does not. All we ever get to know is which one of the multiple possible sequences of events that could have played out actually did, and who profited from that coincidence. While the passing of time may reveal some of the risks that were lurking beneath the surface, we never get to know what all the risks were and how easily they might have come to pass. That is why I say that although returns will always be a fact, risk will always be an opinion. It is something to think about in an industry obsessed with performance league tables that tell you exactly what returns were delivered, but nothing about the risk taken to deliver them.

HOW DOES CORONATION MANAGE RISK?

Managing risk is not something that you should have to clear at the final hurdle in an investment process. We believe it needs to be woven into the DNA of the process, as we endeavour to do in ours.

1. In the research process:
   - **Through a strong valuation discipline** (i.e. paying less for assets than they are intrinsically worth) **and a long time horizon** (i.e. looking through the cycle). Together, these are a great defence against the risk of getting sucked in at the top of the cycle, when prices are high and the risk of permanent capital loss is pronounced.

   - **Through a bias to quality.** We demand significantly higher margins of safety for poor-quality companies, because high-quality companies generally surprise with their growth over long periods and tend to provide the best downside protection in tough economic times. In times of adversity, it is the poor-quality companies that suffer most. High-quality companies are more resilient, and often come out of tough times in a competitively stronger position than they went in with. There is no doubt that this quality bias has resulted in us leaving some return on the table over the years (a situation we are very comfortable with). We will always take a low-risk 30% over a high-risk 50% return. A good example would be gold stocks, which have presented many compelling trading opportunities over the years. We have avoided all of them, because we fundamentally think that they are cyclical, low-return businesses that can always halve just as easily as they can double.

2. In the portfolio construction process:
   - **We spend as much time thinking through portfolio construction as we do researching securities.** Knowing what weighting to give a security is just as important as identifying which securities deserve to make it into the portfolio. We have spent years refining our own proprietary tools to understand overall portfolio positioning, exposure to key risk factors and the risk of unintended bets in a portfolio. The research process will always be the first defence in the risk management process. The portfolio construction process may be a little less sexy and more difficult to articulate, but its contribution is just as significant.

   - **We believe in diversification.** One often hears Buffett's famous comment that diversification results in 'diworsification'. I (respectfully) believe that quote to be somewhat misinterpreted. The 'benchmark hugger' that owns everything in the index clearly adds no value and does nothing but 'diworsify'. However, we believe that a diversified portfolio of undervalued assets is the best defence that any investor has against an uncertain future and markets that eventually humble us all. For this reason, although our portfolios will always represent the high conviction views coming out of our research process, they will always seek to achieve diversification across sectors, geographies and asset classes (where possible).

3. In our cultural values:
   - **Through a team-based investment process.** It is the job of every person in our team to challenge the Coronation portfolio DNA that underpins all our portfolios. As an investment house that has not hedged its bets through multiple teams, boutiques or investment styles, we have no other horses in the race. We simply cannnot afford a low-probability, high-impact event (Nassim Taleb's 'black swan') to derail our portfolios.

   - **We have deep respect for the fact that no one knows the future.** It is a key principle that underpins our investment process. As was appropriately articulated by economist Edgar R. Fiedler, "He who lives by the crystal ball soon learns to eat ground glass". Although we value securities and construct portfolios using a base case scenario, we continually stress-test those assumptions with alternative scenarios.

Ultimately, all investors are judged by their results. A good investment process and an experienced team certainly help, but ultimately it is the runs on the scoreboard that count. We understand this. But at the same time, our clients can find comfort in the fact that we do not get sucked into the temptation to push for returns at the expense of risk. In fact, the converse is true. We live by the maxim that it is often what you get wrong, not what you get right, that defines your long-term track record in investments. For this reason, we leave return on the table every day in pursuit of achieving robust and antifragile portfolios that are your best defence against the uncertain world we live in. ■

RE-OPENING OFFERS OPPORTUNITIES

NEW INVESTORS CAN NOW ACCESS ALL OUR STRATEGIES

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.

In 2012, Coronation closed its South African specialist Equity, Balanced and Absolute Return strategies to new clients. At the time, these strategies represented some 80% of institutional assets under our management. It was a difficult decision, and the scope of the closure was unprecedented in South Africa. Looking back, we believe it was the right call.

The closure was in response to a number of years of exceptional inflows into Coronation portfolios, but enacted before we reached a point where the size of the assets under our management impeded our ability to outperform the market. At the time the decision was taken, we thought it prudent to take action long before our share became disproportionate. As an investment-led firm, we value our track record and our ability to deliver alpha far more than the total assets we have under management.

We always expected to re-open the strategies in due course, given the shrinking formal pension fund market in South Africa. In recent years, assets in these funds have indeed been affected by weak employment amid prolonged economic weakness. In recent years, Coronation has also seen expected outflows materialise.

Careful consideration of the capacity this has created, together with our assessment of market conditions and our five-year forecast of industry trends, has allowed us to re-open our strategies. Coronation remains committed to deliver on the long-term performance objectives of our clients, both existing and new.

PORTFOLIOS AT A GLANCE

The newly re-opened portfolios have delivered strong returns for investors:

Global Balanced strategies

Coronation's two flagship balanced strategies for pre-retirement investments are the Coronation Global Houseview and Coronation Managed portfolios.

The Global Houseview strategy has been managed by our CIO, Karl Leinberger, since 2005 (Sarah-Jane Alexander and Adrian Zetler are co-managers). The Coronation Managed portfolio is managed by Neville Chester (also since 2005) and Pallavi Ambekar is co-manager.

Both strategies have been ranked as top performers in their peer group:

GLOBAL BALANCED STRATEGIES

	Ranking over 1 year	Ranking over 5 years	Ranking over 7 years	Ranking over 10 years
Coronation Global Houseview	1st	1st	1st	2nd
Coronation Managed	1st	1st	1st	1st

Sources: Alexander Forbes Global Manager Watch – Dynamic (Coronation Managed) and Alexander Forbes Global Large Manager Watch survey (Coronation Global Houseview) to end-February 2017

The **Global Houseview** strategy is the top-performing balanced mandate in South Africa since launch, with a 23-year track record of consistent benchmark outperformance over meaningful periods – in all market conditions. It has delivered an annualised return of 16.5% per annum since inception.

The well-diversified portfolio targets long-term growth through an allocation to the most under-valued assets across all asset classes on a risk-adjusted basis, making it ideal for retirement savers. Global Houseview is managed according to the limits of Regulation 28 of the South African Pension Funds Act .

The strategy represents our best investment view for a balanced portfolio in all major asset classes – equities, property, bonds and cash, both in South Africa and abroad. For some time, equities have been Coronation's preferred asset class for producing inflation-beating returns. We prefer global to South African equities on the basis of valuation. The Global Houseview strategy currently has the maximum allowable exposure offshore.

The **Coronation Managed** strategy is our most concentrated rand-denominated global balanced mandate. It has delivered an active annualised return of 17% per annum since inception, with a 20-year track record of consistent benchmark outperformance.

The portfolio, managed according to the limits of Regulation 28, is characterised by high-conviction calls and the potential for significant benchmark divergence. Given its more aggressive mandate, the Coronation Managed strategy typically has a higher allocation to risk assets and tends to have more concentrated exposures. This has helped drive outperformance over the long term. Currently, the fund has exposure to a number of compelling investment opportunities for those prepared to have a longer-term outlook. The strategy is especially suited to retirement funds, corporate investors, trusts and foundations seeking an actively managed balanced portfolio with a long-term investment horizon.

Houseview Equity strategy

Our flagship specialist South African equity portfolio has delivered a return of 17.7% per year since its inception almost 24 years ago. This secured investors an active return (alpha, or market outperformance) of 2.9% per year. This track record has been produced during various market cycles and periods of unprecedented macro volatility.

The consistent long-term alpha produced by the strategy is unique by local and global standards. We believe this is the result of a disciplined focus on investing only in businesses that are trading at a discount to our assessment of their real long-term value. The Coronation Houseview Equity strategy has been managed by our CIO, Karl Leinberger, since 2005. Sarah-Jane Alexander manages assets within the strategy and Adrian Zetler is a co-manager.

Absolute Return strategies

Coronation was the first manager in South Africa to introduce absolute return strategies in 1999. These risk-managed strategies have maintained a strong track record for almost two decades. The real returns generated by the strategies, managed by Charles de Kock (who has 31 years' investment experience) and Duane Cable (head of South African Equity), are shown in the following table:

ABSOLUTE RETURN STRATEGIES

	Inception date	Absolute return since inception (p.a.)	Real return achieved since inception (p.a.)
Coronation Global Absolute	Aug 1999	16.1%	9.8%
Coronation Domestic Absolute	Apr 2002	15.4%	9.4%
Coronation Inflation Plus	Oct 2009	11.1%	5.7%

Returns are shown gross of fees, as at 31 March 2017. Performance shown here is for informational purposes only and is not indicative of performance that would have been achieved in any other Coronation strategy, including those marketed to US investors. Investors should carefully review the materials and disclosures for the strategies they are interested in. Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

Source: Coronation

WHAT LIES AHEAD

Coronation's investment team has enjoyed one of the lowest turnover rates in the industry. We have seen remarkable stability over the past decade, with most of our key portfolio managers remaining in place. We focus on long-term valuations and seek to take advantage of whatever attractive opportunities the market presents us to generate long-term rewards for our investors. This commitment has delivered exceptional returns: more than 95% of our institutional assets have outperformed their respective benchmarks over 10 years and 100% have outperformed their benchmarks over 20 years.

Coronation is a significant manager of retirement savings in South Africa. We are grateful for the loyal support we have received over the years. More than half the institutional assets under our management are from clients who have been with Coronation for more than a decade.

The re-opening of our strategies allows us new opportunities to deliver investment excellence. Over the next few months, we will release Factfiles of our various strategies to re-aquaint you with Coronation's offering. In this edition, we feature Coronation Houseview Equity on page 28. To new clients, the lengthy closure of our strategies shows that we are prepared to make difficult decisions to protect our clients' interests. We really do put our clients first, and will defend their investment outperformance above all else. ■

SBERBANK
A NIMBLE RUSSIAN GIANT

By Lisa Haakman

Lisa is a global emerging markets equity analyst. She joined Coronation in 2016 and has 10 years' investment experience.

Investing in some shares can be like owning fine wine. They may be expensive, but are worth every cent. The finest can be kept for years, are velvety smooth, elegantly balanced, perfectly rounded, immensely satisfying to drink and continue to get better with age.

Sberbank is not that. Some would argue that owning Sberbank is more akin to drinking vodka, an experience conceivably filled with remorse, hangovers and new lows. A common misperception is that Sberbank is cheap and nasty Stoli vodka being downed on the streets. A more intimate knowledge of the company reveals something much more sophisticated. Founded in 1841, with 139 million customers, Sberbank is more Grey Goose (steeped in heritage) or Smirnoff (the largest vodka brand globally) than it is Russian Bear!

Let us put this in context. With 139 million retail customers, Sberbank is ...

- twice as big as Wells Fargo, the largest retail bank in the US;
- nearly five times the size of Lloyds Bank, the largest retail bank in the UK; and
- over 10 times as big as Standard Bank, the largest retail bank in South Africa.

In addition to its massive retail base, Sberbank manages 1.5 million corporate customers through 15 700 branches, 82 000 ATMs and 328 000 employees.

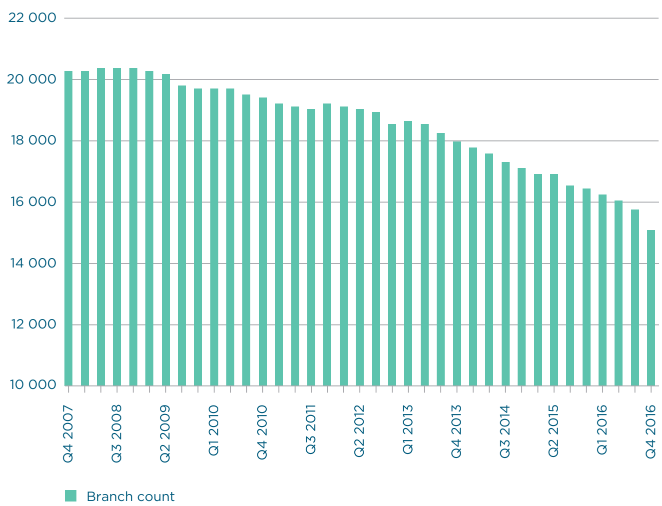
Sberbank has a market share of almost 40% of retail loans and 46% of retail deposits. On the corporate banking side, it has a 32% share of corporate loans and almost 23% of corporate deposits. Its nearest peer, VTB, holds only 10% of retail deposits and 22% of corporate deposits. Outside of these two players, the market is very fragmented. Consequently, Sberbank is the dominant bank in the Russian market by an order of magnitude.

Sberbank enjoys a number of competitive advantages over its peers, including a lower cost of funding and superior digital capabilities. Not only do retail deposits constitute a higher proportion of its funding base than its peers', but it also pays less on these deposits due to the perceived safety of the bank. On the digital side, the Sberbank behemoth is managed through one centralised IT system. Yes, one. Since 2008, it has invested heavily in its IT platform, rationalising its IT infrastructure from over 2 500 systems to a single system today, a phenomenal feat by any global standard.

As a result of its scale and its IT system, Sberbank has one of the lowest cost-to-income ratios of any universal bank, at only 39.7% (its peer group would be immensely proud of a number sub-50%). Consequently, Sberbank is able to price loans substantially lower than competitors to earn the same return on assets, resulting in positive selection for itself and negative selection for the peer group.

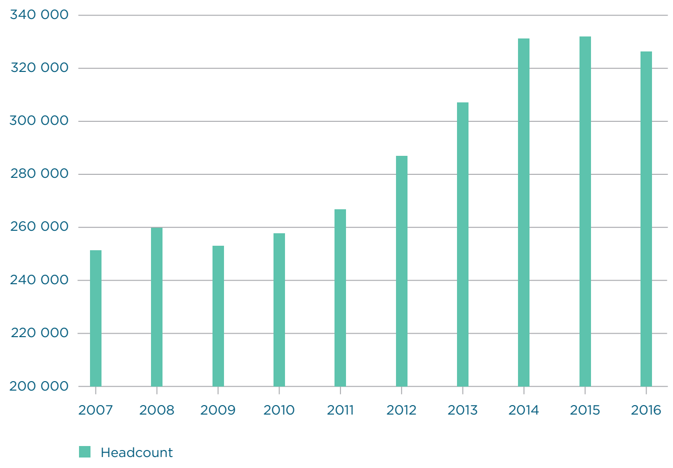
In addition, big data analytics have resulted in significant time savings in decision-making, and a 98% reduction in processing time. Almost 34 million customers are using the web or the Sberbank app as their primary banking channel

SBERBANK BRANCH COUNT



Source: Sberbank

SBERBANK HEADCOUNT



Source: Sberbank

The bank has a very long runway for growth, evidenced by Russia's low banking penetration by global standards – domestic credit is 59.3% of GDP compared with the OECD average of 109% of GDP. In addition, the nonbanking financial services market (insurance, wealth management and pension management) is in its infancy. Sberbank has plans to capture market share in the underpenetrated mortgage market, and with respect to the nonbanking financial services industry will likely create a market that currently is almost nonexistent. By way of comparison, Sberbank currently operates the largest asset manager in the country with a market share of 24%, yet manages only $15 billion of assets. To put this in perspective, Coronation has more assets under management than all of Russia. Also, Sberbank is the largest life insurer in Russia, with a market share of 29% – yet premium income was only $1 billion in 2016. Total insurance premiums represent only 1% of GDP, extraordinarily low even for emerging market countries, as per the International Monetary Fund data below.

and a staggering 91% of all transactions are now conducted via digital channels or ATMs. As a result, Sberbank is in a position to start reducing and rationalising both its branch footprint and its staff headcount.

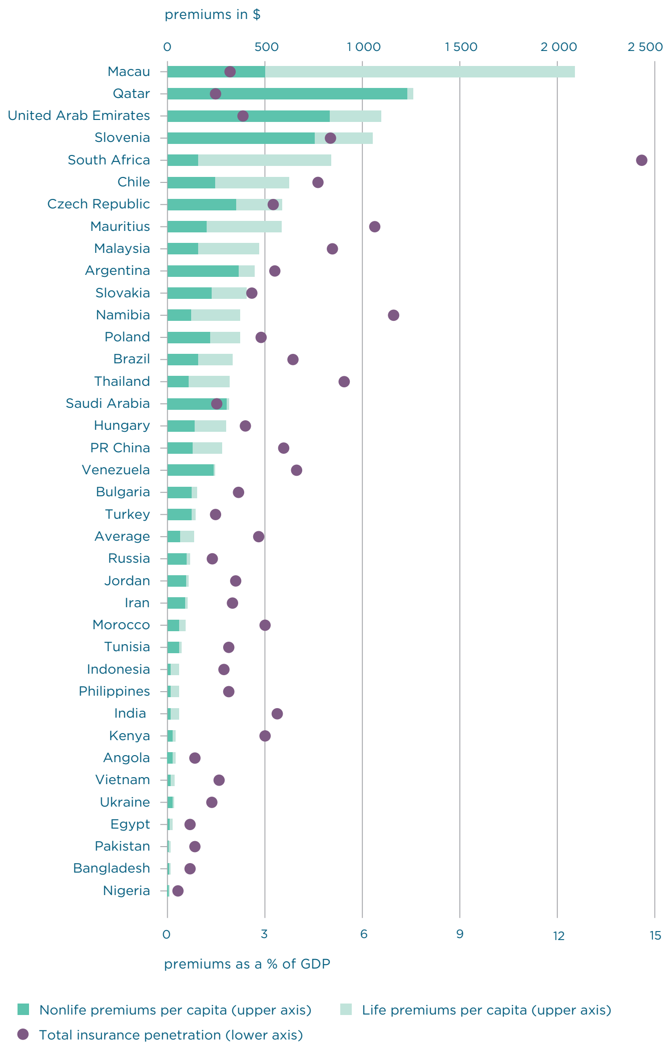
In the fullness of time, management believe they can reduce the number of branches by 25% and the headcount by at least 50%. This then becomes a virtuous circle, reducing Sberbank's cost-to-income ratio further and rendering its peers even less competitive.

This world-class cost-to-income ratio is one of the primary reasons Sberbank enjoys one of the highest returns on equity (ROE) of any bank globally, currently almost 21%. There is scope to increase this ROE further, yet the share trades at only 1.1 times forward book, well below its fair value.

In addition, Sberbank carries optionality via a potential joint venture with one of the world's internet giants. Yandex, Mail.ru (Naspers) and AliExpress.ru (Alibaba) have all engaged in discussions with Sberbank to serve as the backbone of its e-commerce platform in Russia. To date, none of these negotiations has resulted in a deal; however, should such a deal emerge, this would represent significant upside that we are not paying for at the current price.

As banks increasingly become indistinguishable from technology companies, we believe we are backing a winner. Over and above a superior cloud-based IT system, Sberbank is already piloting blockchain, machine learning and artificial intelligence 'bots', each of which could make a significant positive impact on both the customer experience and the cost to serve. Many of Sberbank's products, such as Smartkassa, have changed the way small businesses operate, offering online payments, card payments, accounting, reporting, customer relationship management and other banking services in a single point-of-sale device.

INSURANCE DENSITY AND PENETRATION IN EMERGING MARKETS (2015)



Source: Swiss Re Economic Research & Consulting

We believe Sberbank is best placed to capture these opportunities.

Still, we acknowledge the risks involved in being a minority shareholder in a state-owned bank, especially in Russia. However, under the capable leadership of Herman Gref, CEO since 2007, minority shareholders have been fiercely protected. The macro environment, while always prone to shocks, is improving, and the likelihood is that sanctions against Russia will be eased over time. Nevertheless, we factor these risks into our valuation. The share is trading at 5.5 times our estimated 2017 earnings and 1.1 times our estimate of 2017 net asset value, and carries a dividend yield of almost 4%. On this basis, we believe the share is very attractively priced and we are optimistic that future returns will be cause for celebration. Na zdorov'ye! ■

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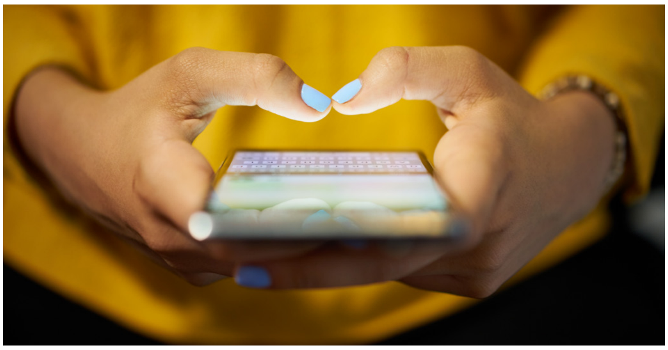


MTN

DOWN BUT NOT OUT

by Pallavi Ambekar

Pallavi joined Coronation in 2003 and manages assets within Coronation's Aggressive Equity Strategy. She has 14 years' investment experience.

"He who is not courageous enough to take risks will accomplish nothing in life." – Muhammad Ali

MTN came out of 2016 battered and bruised. The $5.2 billion fine on its Nigerian operations over unregistered SIM cards dealt a massive blow to its image as an African champion in mobile telephony. However, Nigeria was not MTN's only hot spot last year. Many of its other operations also battled weakening economies as well as governments that were keen to bolster fiscal revenues by targeting cash-rich corporate entities. In addition to increasing regulatory demands for customer SIM card registration, MTN found itself subject to additional taxes and obligations in some markets to localise ownership of its subsidiaries. Internally, the company was attempting to stabilise its senior management team and to catch up on data network investment in key markets. Difficulties around the fine were compounded by constraints on extracting cash out of Nigeria, and there were concerns about the sustainability of the company's dividend payment.

Recently released annual results for the year ended December 2016 saw continued pressure on MTN's earnings, reflecting the tough environment and internal turmoil at the company. It did, however, manage to keep to its commitment to pay out a R7 dividend for the full year, and has committed to keep this flat for the 2017 financial year. With the fine settlement behind it and the rebasing of earnings, MTN now faces a critical turning point to prove whether it can capitalise on the still latent growth opportunity in its operations. It is certainly well equipped to do so. It commands strong, leading positions in most of its regions. It can also use tough times to entrench its moat by investing in infrastructure, while its competitors struggle with financing. With proper management execution, we think the next leg of growth for MTN will be delivered over the coming few years.

Historic growth witnessed in MTN's early years was driven by entering virgin markets and building scale and coverage quickly. MTN enjoyed first-mover advantage, which resulted in it easily obtaining a large customer base that previously had very little access to communication. Once the business had built scale, however, it struggled with transitioning from an entrepreneurial operation to a professional organisation. Management's focus on cost efficiencies and cash generation came at the expense of network investment in data capacity and providing customers with high-quality service. As a result, the company allowed competitors to take valuable market share.

The Nigerian fine was a significant shock. While it was a major negative event, we think it forced the board into taking fundamental strategic steps to address complacency. The

RECENT APPOINTMENTS AT MTN*

Name	Position	Announcement	Office start date	Former key position
Rob Shuter	President/CEO	Jun 16	Mar 17	Served as head of Vodafone's European cluster
Ralph Mupita	CFO	Oct 16	Apr 17	CFO of Old Mutual Emerging Markets
Jens Schulte Bockum	Group COO	Dec 16	Jan 17	CEO of Vodafone Germany
Bernice Samuels	Group CMO	Dec 16	Jan 17	Marketing officer at MTN South Africa and First National Bank; Executive Director of Strategy and Business Development at SABMiller in South Africa
Oliver Fortuin	Enterprise segment head	Dec 16	Mar 17	CEO of BT Global Services sub-Saharan Africa
Felleng Sekha	Executive for regulatory affairs and public policy	Oct 16	Oct 16	Various roles in MTN including executive director for corporate services in Nigeria
Stephen van Coller	M&A/Strategy head	Jul 16	Oct 16	Barclays Africa head of investment
Kholekile Ndamase	Deputy head M&A	Jul 16	Sept 16	Led equity-based financing business at Rand Merchant Bank
Godfrey Motsa	Vice-president for South and East Africa	Jun 16	Jul 16	Vodacom's chief officer for consumer business
Babak Fouladi	Group executive for technology and information systems	May 16	May 16	CTO of Vodafone Spain
Giovanni Chiarelli	CTIO of MTN South Africa	Nov 16	Nov 16	CTO of Vodafone Romania

*Highlighted management members were at Vodafone previously.

Source: Bank of America Merrill Lynch Global Research

introduction of a new, experienced senior management team will enhance the ability of the company to deliver on its growth potential. These new appointments bring fresh energy to the company. They are also capable of addressing the underlying issues on a clean-slate basis, without any ties to legacy thinking.

Future growth in MTN will come from three areas:

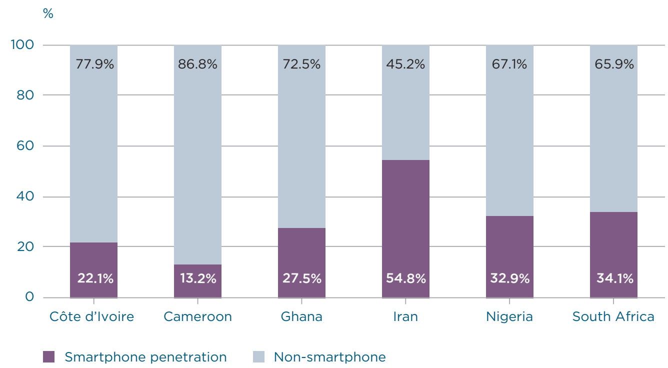
- managing the existing base business better;
- accelerating the growth of new adjacent revenue streams; and
- good capital allocation.

While MTN has built a big business, it has not made the most of leveraging its scale. It has done some work to improve purchasing power in network equipment and handsets, but it has not been able to put in place a central steering function that is able to give coordinated direction to each of the operational companies. The new management team will implement this central model, which will enable regions to drive market strategies quickly and intelligently. Management is also focused on the very basics of network deployment, and is looking to improve network availability by using spectrum more efficiently and increasing 4G tower rollout (which will improve data capacity). These actions were first implemented in South Africa and Nigeria, and will be implemented in other operations during 2017. Network improvements will be coupled with the standardisation of business metrics and the upgrading of IT systems, which will allow for greater customer and business analytics. Combined, the increased quality of service and enhanced management information should enable MTN to grow market share and accelerate data revenue growth.

While business basics are being addressed, there is also a clear opportunity to grow revenue streams that are complementary to basic voice and data services. Smartphone penetration in MTN's main markets is set to increase as handsets become more affordable. Customers are also using these handsets to perform more transactions and consume more content. MTN has already rolled out some of these services (music, gaming and mobile money) and they are growing strongly, with reported revenue growth of 44% (off a low base) in 2016.

This is not uncharted territory. Safaricom in Kenya is a good example of how a mobile telephony business can successfully leverage its scale to grow into a new category. M-Pesa (Safaricom's mobile money product) has 16.6 million active subscribers, and mobile money now contributes 22% of Safaricom's total revenues. MTN has 20 million mobile money subscribers, concentrated mostly in Ghana and Cameroon. We do not expect MTN to replicate the full success of Safaricom across all of its operations, but there is potential to capture more of the financial services income stream in Africa. This will come via the rollout of mobile money products into more countries (mobile money is only in five of MTN's operating countries at the moment) and the launch of new financial products (such as remittances, microlending and savings products) in addition to basic payments and airtime purchases.

SMARTPHONE PENETRATION IN MTN'S KEY MARKETS STILL LOW



Source: MTN 2016 annual results release

We expect these initiatives to support healthy organic earnings growth over the medium term. In addition, as the company comes out of a heavy capital expenditure cycle, it will convert a high percentage of earnings into cash flows. The business has a good track record of cash conversion – over the past 10 years it has converted about 85% of its earnings into cash. This will be supportive of growth in dividend payments to shareholders. There is also the opportunity to realise further value from the future sale of tower investment assets and digital investments. The current share price attributes little to no value to these investments, and presents another leg of optionality in the investment case.

Some market participants believe MTN is a broken business. We do not think this is the case. The company has weathered a particularly nasty period but has come out of it focused and better equipped to deal with a complex environment. The earnings base is low, and expectations are not high. We acknowledge that there are risks in how this investment case plays out, but feel that these risks are more than adequately discounted in the current share price. Our analysis of past case studies shows that investors tend to underestimate the upside case when new management teams come into undermanaged businesses with good fundamentals. In an uncertain investment environment, we think that MTN presents a powerful combination of attractive fundamentals and self-help initiatives, at an undemanding valuation. ■

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FORMALISING THE INFORMAL

OPPORTUNITIES IN FRONTIER MARKETS

By Gregory Longe

Gregory is an investment analyst within the Global Frontiers investment unit. He joined Coronation in February 2013 after completing his audit training at Ernst & Young.

After a tough week – or even a particularly good one – indulging in a guilty pleasure brings enjoyment to millions across the globe. In a high-end bar in London, it may be an e-cigarette paired with a top-shelf whiskey or craft gin (served with Fever-Tree tonic water, of course). In a shebeen in Lusaka, it might be a scud of Chibuku. In Colombo, a beedi and a cup of toddy. The location and refreshments may differ, but the ritual remains the same – and businesses built around meeting these needs have become some of the largest and most successful in the world. It is no surprise then that shareholders in these global giants have been handsomely rewarded.

Our Global Frontiers strategies look to invest in the emerging markets of tomorrow. These are countries characterised by tremendous opportunity and strong economic growth, but also by low levels of economic development. Infrastructure is often poor, banking penetration low and formal retail limited. Out of necessity, and often ingenuity, the informal sector in these markets is usually sizeable. As a result, many larger companies find themselves competing with both formal and informal players. This can be tough, given the questionable tax compliance practices, patchy health and safety records, and low cost bases associated with the informal sector. Despite these challenges, however, companies that can find the right value proposition have seen customers happily pay for the benefit of a safe, consistent product. Competition from the informal sector is particularly fierce for the large alcohol and tobacco companies. But it is also this competition that gives rise to some of the most exciting opportunities.

INFORMAL HOME BREWS IN AFRICA

SABMiller (SAB), now part of Anheuser-Busch InBev, has a long history on the African continent. With roots stretching back to 1895, it has spent over 100 years competing with traditional or opaque beers in Southern Africa. Opaque beer is typically fermented in small quantities from sorghum or maize. It has been drunk for thousands of years in villages across the continent, and is brewed based on recipes passed down through generations. Drinking opaque beer at social occasions is part of the cultural fabric of rural villages and urban capitals across sub-Saharan Africa.

With the introduction of Chibuku, SAB's opaque beer, the brewer has been able to formalise the mass brewing of traditional beer, tapping into the informal home brew opportunity in 10 countries to date. It has profited from offering an affordable, safe and consistent alternative to small-scale backyard brewers. By formalising the informal sector, it has also brought these profits into the tax net, which benefits the governments in these countries. In Zimbabwe, one of the first markets to sell Chibuku, opaque beer sales amount to triple the volume of lager beer sales and account for double the profits.

Chibuku broadened SAB's product offering and allowed it to move beyond the clear beer or lager market. Formalising the informal beer market also helped SAB capture a larger share of the total alcohol market. A secondary impact is that Chibuku makes the business more stable and less cyclical. Periods of increased consumer spending see beer drinkers trade up from opaque beer to lager beer, while recessions see down-trading from lager to opaque beer. SAB is able to capture the full range of consumption in both economic environments. In addition to Zimbabwe, this exciting story is currently playing out in South Africa, Botswana, Ghana, Malawi, Mozambique, Tanzania, Zambia, Lesotho and Swaziland. The opaque beer opportunity is also part of our investment case for holding the brewers in some of these countries.

BEEDIES IN ASIA

A more nascent opportunity lies in beedies. Beedies are small, hand-rolled cigarettes made of tobacco flakes wrapped in leaves and tied with colourful string. Beedies are prevalent in India and much of Southeast Asia, and are a very low-cost alternative to cigarettes. However, the industry is synonymous with child labour and beedi smoking is considered to be significantly more harmful than cigarettes. While no global cigarette company has found a way to compete with the beedi industry yet, we believe that the formalisation opportunity in Sri Lanka is particularly interesting.

Ceylon Tobacco Company (CTC), a British American Tobacco subsidiary, has a monopoly in Sri Lanka's formal cigarette market. However, this does not tell the full story, as beedies account for 45% of the total tobacco market. For CTC, the opportunity to produce a beedi-type product will see its addressable market almost double. Machine-rolled beedies will be safer than informal beedies, and cheaper than cigarettes. Entering this market would therefore allow CTC to grow volumes, while customers would be able to consume a less harmful product. As is the case with Chibuku in Africa, the Sri Lankan government also stands to benefit, as any profits from beedi sales would be taxable (which is unlikely to be the case today). Furthermore, applying global health and safety practices to the beedi industry should be positive for lawmakers and should help keep more children in schools.

CTC is currently pursuing the beedi opportunity. If successful, we have no doubt that the technology will be rolled out into other markets. Bangladesh, where beedies account for 40% of the tobacco market, is another prime candidate for formalisation. Even in an industry such as tobacco where volumes are declining, the company that is able to formalise the informal sector can see a return to growth.

As we scour the world's frontier markets looking for investment opportunities, we often come across companies innovatively meeting their customers' needs. As these economies move from frontier to emerging market status, we will no doubt see more examples of this. The governments in these countries stand to benefit. Consumers stand to benefit. And hopefully, as shareholders, we will benefit as well. Now surely that is something to toast to. ■

As long-term investors, environmental, social and governance (ESG) considerations are fully integrated into our investment process and form part of the mosaic for any investment case, in understanding the long-term sustainability of companies and their business worth. When valuing a business, we take ESG factors into account predominantly by adjusting the discount rate applied to the assessment of its normalised earnings. We therefore implicitly build the risks relating to ESG considerations into the ratings of the businesses we analyse. Where we can, we explicitly allow for ESG costs in the modelling of a company's earnings. We do not exclude investments in companies that perform poorly on ESG screens, but we do require greater risk-adjusted upside before investing. In practice, a business with an ambiguous ESG profile will be required to deliver higher returns to justify its inclusion in the portfolio.

Social objectives vary significantly between investors, and ESG issues are often intrinsically fraught with ambiguity. We engage with segregated clients on significant ESG issues to ascertain if we should apply specific screens or exclusions to their portfolios.

GLOBAL ECONOMY

STRONG GROWTH MOMENTUM BIGGER THAN POLITICS, FOR NOW

By Marie Antelme

Marie is an economist within the fixed interest investment unit. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

While politics continue to play in the background (and flare-ups have been frequent), the start of 2017 has confirmed that global growth momentum continues to build. GDP growth forecasts for the year have been revised up, as data out of Europe and parts of the emerging markets complex have surprised to the upside. Bottom-up forecasts suggest that global GDP growth should be about 3% for this year, with the real surprises being strong growth momentum in Europe, ongoing resilience in the US and a very strong turnout for Chinese growth at the start of the year.

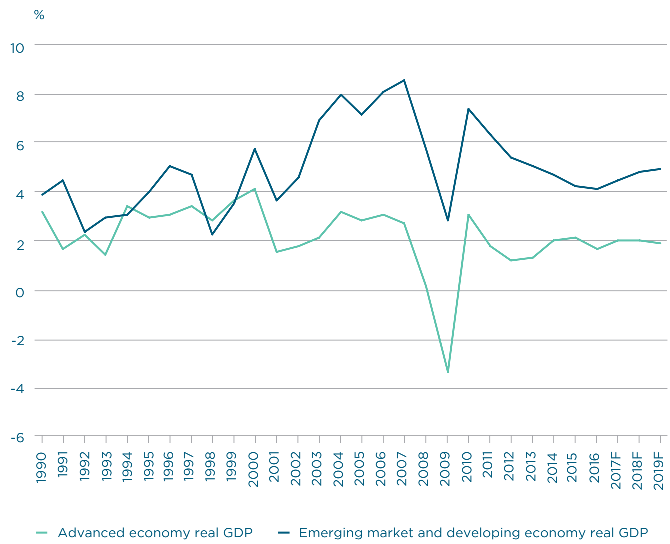
The economic recovery looks broad based at this stage, and well supported by a powerful recovery in manufacturing activity against the backdrop of a strong uptick in business and household confidence. Inflation has also re-emerged and, with the resurgence in economic activity, has re-opened the debate about monetary policy settings in developed economies. The recovery in nominal GDP globally has also been good for corporate profitability, which has shown signs of improvement after two years of weakness. If sustained, this should support both investment and hiring.

The outlook for global growth from here is hard to assess. The interplay between long-term trends (such as ageing populations and moderating productivity), accelerating growth that is still supported by extremely accommodative policy settings (which are arguably now no longer as necessary) and both political and economic shocks makes the narrative very hard to align.

Following elevated expectations that president Trump would deliver early fiscal stimulus, slow administrative processes have led most forecasters to push expectations out. Data also show that the first quarter of 2017 got off to a soft start, with warm weather, inventories and net exports a spill-over drag from the end of 2016. However, incoming data point to a healthier, more enduring mix of rising business confidence and an acceleration in capital expenditure.

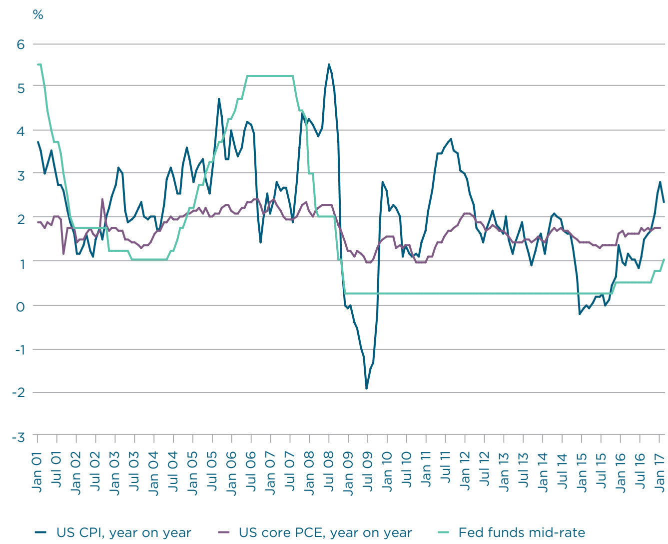
Strong payrolls growth early in the year should also support household spending. Overall US growth is forecast at about 2% (slightly ahead of potential) in 2017, with anticipated fiscal stimulus expected to be an accelerant into 2018.

GLOBAL GDP (REAL)



Source: International Monetary Fund World Economic Outlook

US INFLATION AND POLICY RATE



Source: Reuters Datastream

The annual growth rate of the core PCE deflator, the US Federal Reserve's preferred inflation metric, has risen from a recent trough of 1.3% year on year (July 2015) to 1.8% in February. CPI data were stronger than anticipated too, up 2.4% year on year from 2.8%. Reflecting a more buoyant economic environment, the Federal Open Market Committee voted to raise the federal funds rate a further 25 basis points (bps) to 1.0% in March, and indicated the central forecast among members for a further two 25 bps rate hikes this year as most likely.

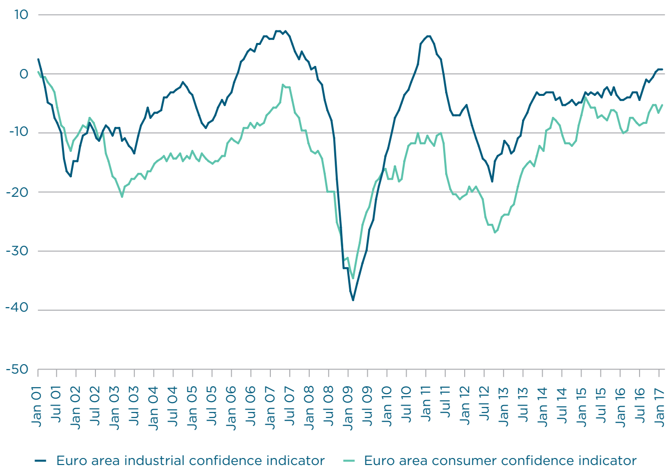
The outlook for the US is not without its challenges. President Trump met heavy opposition when trying to repeal the Obamacare health bill, and failure to do so has jeopardised his tax plans. In the meantime, the US has reached its debt ceiling, and while fancy footwork can avoid a government shutdown until there is a vote to extend the funding limitations, the window to do so will narrow into the summer. The tense rhetoric between the US and both Russia and North Korea has the potential to flare and is likely to be an ongoing source of uncertainty.

In Europe, politics remain in focus. With the French elections underway, National Front candidate Marine le Pen continues to do well in the polls, while both independent contender Emmanuel Macron and François Fillon recovered some early slippage heading into the election. Interestingly, the leftist candidate, Jean-Luc Mélenchon, saw some late popularity before voting commenced, making the election another one that was simply too close to call at the time of writing. This is arguably the most important election in Europe this year. Here, the outcome could have a binary impact on France's economy – Le Pen may create a vacuum in which France becomes uninvestible for a time. Both Macron and Fillon have reformist agendas (which could see significant changes to economic policy) while Mélenchon supports expanded welfare programmes and increased labour rights, and has called for wealth redistribution to rectify inequalities.

Elsewhere, elections in the Netherlands saw right-wing candidate Geert Wilders defeated and a more moderate centrist coalition government negotiated. Greece has also re-entered the spotlight as concerns about ongoing bailout funding re-emerged in February. The conclusion of the second bailout programme review still does not seem imminent and Greece owes debt repayments of approximately €1.5 billion by the end of April – before a staggering €7 billion is due to be repaid in July.

On the European data front, December and January's strong momentum continued through March: Eurostat's flash estimate for eurozone GDP came out stronger than expected for the last quarter of 2016, at 0.5% quarter on quarter and 1.8% year on year, with an upward revision in the third quarter of 2016 to 0.4%. This brought GDP growth of 1.7% in 2016, slightly ahead of the 1.6% consensus. Since then, confidence readings have become elevated, suggesting some durability to the upswing. Inflation prints in Europe rose early, but then slipped again in March to just 1.5% year on year. The European Central Bank (ECB) will be watching closely to see if the moderation in March is sustained. German inflation remains a key indicator of pricing pressure, and with a tight labour market, wages are being closely monitored. German consumer inflation accelerated to 1.6% year on year in March.

EURO AREA: CONFIDENCE INDICATORS



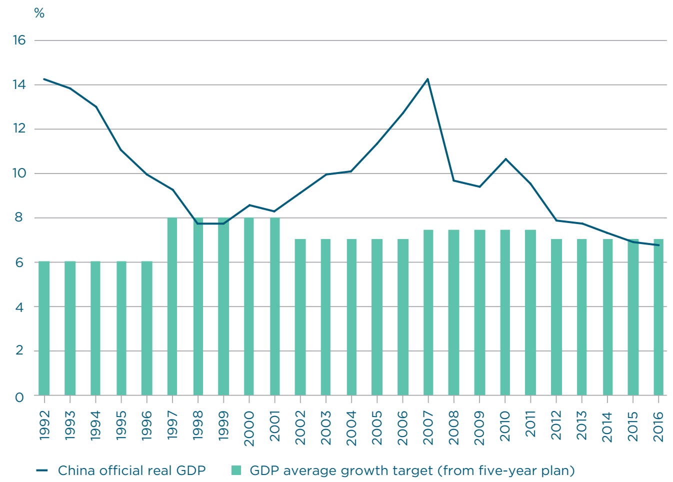
Source: Reuters Datastream

Rising inflation has raised speculation that the ECB might raise rates before it concludes its asset purchase programme. However, ECB governor Mario Draghi appears to have indicated that the ECB will not change policy rates until the current round of quantitative easing runs out at the end of 2018. Given the strength of the eurozone recovery, it seems more likely that the process of tapering ECB asset purchases might slow during the course of next year.

In the UK, prime minister Theresa May has announced early elections, scheduled for 8 June. With the Labour Party very weak, the election should allow May to secure another term, and progress with Brexit negotiations as the election calendar in Europe tapers in the second half of the year. Having formally notified the EU of the UK's intention to leave the union, the complicated and uncertain negotiation process is set to start. At this stage, European counterparties seem adamant that they will not allow the UK to negotiate its withdrawal in parallel to the necessary new trade and business agreements with member countries, but delays could negatively impact confidence and growth in the UK. Most of the negotiations will take a backseat while the European election calendar runs this year, which will put pressure on those involved to meet the two-year deadline in early 2019. Policy settings in the UK are likely to be put on hold. Inflation data showed CPI rising to 1.8% year on year in February. While this slightly undershot expectations, Producer Price Index input prices continued to rise, now recording 20.5% year on year. In contrast to rising inflation, average weekly wages decelerated from 2.8% to 2.6%. UK retail sales also surprised to the downside.

Strong growth in China in the second half of 2016 provided significant support for commodity prices globally, and the gains seem to be relatively broad based.

CHINA: ACTUAL AND TARGETED GDP



Sources: Reuters Datastream, Gavekal

Official growth statistics for the first quarter of 2017 show that the Chinese economy grew by 6.9% year on year – ahead of the official target of 6.5%. This resulted largely from good infrastructure growth and strong property sales. Consumption remains resilient, in turn supported by solid nominal wage growth. Overall, however, ongoing excessive growth in debt, mostly via the nontraditional banking sector, remains the overriding concern for the Chinese economy. For now, the risk of a sudden stop seems a little while away, as momentum – and policy – support growth within a range of the government's 6.5% target.

The brighter picture for global growth will go some way to ease the millstone of high debt, and will perhaps also slightly delay the need for desperate structural reform in many developed economies. But the cyclical upswing is unlikely to be of sufficient duration or momentum to provide a growth groundswell that facilitates more sustainable fiscal positions. In addition, growth does not come without its challenges. The processes by which developed economy central banks start to normalise policy settings may be disruptive and will undoubtedly have consequences for the heavily indebted governments that have benefited enormously from abnormally low global interest rates. As is almost always the case – although seldom in as fluid and uncertain an environment as the world is now – politics is more likely than not to complicate, compromise and cripple the process. ■

INTERNATIONAL OUTLOOK

OPERATING IN UNUSUAL TIMES

By Tony Gibson

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.

STRONG MARKET PERFORMANCE

All in all, the first quarter of 2017 was another good one for global asset performance. Although weakness in the US dollar somewhat flattered returns, almost every asset class delivered a positive total return – with the exception of certain commodities. Gold reversed its position as the worst-performing asset class of the fourth quarter of 2016 to end at the top of the performance tables in the first quarter of 2017, rising 8.4%. Global equities also did well, rising 6.9% and thereby continuing to outperform bonds (as has been the case since the global low point in yields seen around the time of the Brexit vote). The best returns came from the global technology sector, which rose 12%. To put this in perspective, it is worth noting that the top four megacaps of the sector (Apple, Alphabet, Amazon and Facebook) now have a combined market capitalisation twice that of the French CAC 40 Index. Energy was the only sector not to deliver positive performance, falling 5% on the back of lower oil prices.

In the bond and credit markets, returns largely appear to have followed a pattern commensurate with asset risk. Therefore, the lower the credit rating, the better the return.

This is illustrated by the fact that despite the interest rate hike by the US Federal Reserve (Fed) in March, emerging market debt (in local currency) performed very strongly, producing a 6.4% total return. Additionally, returns were boosted by strength in emerging market currencies, with the Mexican peso, Russian rouble and Korean won rising 8% to 10% against the US dollar. Interestingly, despite a more hawkish Fed, US Treasury yields moved lower over the quarter, albeit marginally. In the currency market, the clear trend during the quarter was that investors' long-standing preference for the US dollar has declined, with the currency underperforming every other major currency during the quarter. The Australian dollar (+6%) and Japanese yen (+5%) were the standout performers among developed market currencies.

ECONOMIC OUTLOOK

Looking at economic statistics, global nominal GDP appears to be on track to record its second consecutive 6% annualised quarterly gain in the first quarter of 2017. This will represent a sharp acceleration from the 4.5% annualised growth rate over the previous two years. Supporting this assertion is the fact that manufacturing output growth is accelerating to a pace of 4.6% for the quarter, suggesting a significant boost from a positive turn in the inventory cycle. The strength in manufacturing activity appears to have been broad based, and has prompted economists to revise their GDP forecasts – particularly for western Europe and Asia.

As we already know, the US economy grew more modestly during the fourth quarter of 2016. That said, the US is also starting to experience the global pick-up in manufacturing (output is tracking a 3.8% annualised rise this quarter) and sentiment is improving. It seems probable that US economic growth is poised to bounce back to a level of around 3% as the year progresses, fuelling a faster gain in overall global GDP for the next couple of quarters.

Looking at Europe, growth dynamics in the region continue to improve: the European Commission's Economic Sentiment Indicator is at a six-year high, the German Ifo Business Climate Index is improving and the European labour market is tightening. Again, economists are steadily revising their 2017 growth outlook for the region upwards. Given the pace of labour market tightening, it was somewhat unexpected that core inflation in March surprised significantly to the downside. At an annual rate of 0.7%, core inflation is now back at the low end of an already low four-year range. However, beyond this year, changing labour market dynamics should begin to put upward pressure on prices. While core inflation may only rise to 1.4% (year on year) by the end of 2018, the upward momentum in both growth and inflation should be sufficient to trigger quantitative easing tapering early next year. That said, the first rate hike from the European Central Bank (ECB) will most likely not come until late 2018. This forecast is reinforced by recent ECB comments.

ALL EYES ON THE TRUMP ADMINISTRATION

Looking towards the medium term, it should be noted that the US Standard & Poor's (S&P) 500 Index had been moving broadly sideways for nearly two years during the build-up to the 2016 US election. This period of muted performance coincided with the Fed beginning to normalise policy, during a time in which the economy was mired in a stop-go pattern of growth. Additionally, corporate earnings actually declined (mostly because of reported earnings declines from companies in the energy sector) during 2016. Then along came Donald Trump and the equity market changed tack, as it wholeheartedly embraced his reflation argument. The strongly bullish line of argument was that growth would be energised by a combination of deregulation, tax cuts and infrastructure spending.

Thus far, little that is either elegant or convincing has been forthcoming from the Trump administration. Investors have increasingly begun to wonder whether the recent healthcare reform failure is telling of how Trump's other main policy proposals may play out. It has also raised questions about whether his policies will be sufficient to generate a sustained increase in the growth rate of the US economy. A worry is that tax reform legislation will be just as hard to achieve following the healthcare reform failure.

Additionally, financial deregulation could face significant opposition and infrastructure spending plans may have a more muted impact on the economy than many believe, as it appears these plans are based on tax credits that will rely on private sector investment. Either way, whether positive or negative on the Trump administration, the events of recent weeks have to cast doubt on just how successful Trump will be in boosting the US economy.

Certainly, after the strong gains following Trump's election, investors are more cautious that the healthcare debacle will have a negative impact on sentiment in the US. The question is essentially whether survey data were 'leading' actual economic data or simply getting carried away. The most recent US Purchasing Managers' Index release for February disappointed. That said, the services sector remains strong.

GRADUAL NORMALISATION

Taking a longer-term perspective, although fears of an unstoppable deflationary global contraction have reduced in recent months, expectations for a prolonged disinflationary environment are still built into developed world financial markets. The multi-year rationalisation, and acceptance, of negative real returns on short- and medium-term debt is fed by the self-reinforcing effect of momentum investing. This has distorted borrowing and investing patterns, and should not be seen as sustainable by any rational investor. As a reminder, and to offer perspective, US 10-year Treasury yields fell from the early 1980s to a low of just over 1.4% in mid-2012, and back to that low again in mid-2016. During the time before these already low yields were exaggerated by Fed bond buying, 10-year yields traded in a range between 4% and 5% from mid-2002 through to mid-2008.

Over the coming two to three years, as the Fed continues to raise short-term borrowing rates, it will also begin to retire (rather than reinvest) maturing Treasuries in its portfolio. Without this bond demand distortion (which has been in force since 2009), 10-year yields should continue to 'normalise' and slowly rise back to and above 3%. During this period, bondholders will most likely question the scenario again and might believe that tepid global growth – combined with the glut of global savings, continued bond buying by the ECB and the Bank of Japan, and (yet more) political gridlock in the US – will offset the reduction in Fed bond buying. This (bond-bull) argument therefore believes that further raising the federal funds rate would merely flatten the yield curve, slow the modest domestic recovery and force the Fed to pause – or even loosen again later next year or in 2019. We believe that this is bond-bull rationalisation rather than sound logic.

While prices of basic materials have risen significantly from depressed levels a year ago, the price of gold has remained relatively flat in US dollar terms. To give some context, year-on-year prices of natural gas, crude oil and copper are up by 69%, 34% and 21% respectively. By comparison, the price of gold rose by just 7% over this period. While the price behaviour of gold implies limited immediate inflationary price pressure, the year-on-year increase in the price of oil has triggered a near-term inflationary effect that will move through the supply chain during the course of 2017. Despite this, it is unlikely that the rise in the price of oil will materially suppress consumer spending power in the US, since most of the jump resulted from the over-sold conditions prevailing a year ago. More important is whether sustained higher energy prices later this year might trigger a second round of inflationary effects, which would lead to expectations of higher wage and consumer prices into 2018.

CHANGE IS COMING

It is our opinion that during the next two years, the outlook points to a modest upturn in global economic activity, resulting in a synchronised period of global growth. This will be led by the US and will be supported by continued momentum from China and India. In China, it appears that to protect its consolidation of power, China's ruling elite needs to support the momentum of growth this year. This in turn should support a further rise in base metal prices.

As mentioned, the recent cyclical upturn in commodity prices should add to input price pressure over the next 12 to 18 months. Worryingly, over the longer term it appears likely that the global economic growth rate is set to slow and increasingly diverge between regions.

In examining likely future trends, investors need to be reminded that momentum investing (whether on a macro or share selection level) becomes self-fulfilling. In the late 1970s, inflationary expectations shaped group think, while by the late 1980s, it was Japan's export-driven economic boom. A decade later, the collective focus had shifted to a US-led, tech-driven investment boom. By 2007, the masses of momentum investing were seduced by expectations of a super-long-term, China-driven commodity super cycle. The subsequent collapse, caused by the leverage-driven risk peak in 2008, led the next wave of consensus toward deflationary expectations. This saw the rationalisation of negative real interest rates and a critical mass of investors assuming chronic slow growth, a global savings surplus and a glut of production capacity. Distilled into one line, the belief was that interest rates would remain lower for longer for many years into the future.

All we can state with reasonable certainty is that looking ahead over the next 10 years, the environment that will shape the late 2020s is likely to be far different from the influences that shaped the critical mass of consensus thinking that exists today. We believe that the world will most likely be moving from the current period (which encourages excess savings and is characterised by lower debt yields) towards a period of demographic divergence, during which modest growth in the US will be insufficient to compensate for the ongoing contraction in most of Europe and North Asia. The worry is that rapidly ageing populations, and the resultant negative effect on economic growth, will drain savings and set in motion a process leading towards higher capital costs and reflation. As mentioned above, in each of the past five decades, such a transition and the resulting shift in the direction of momentum investing will be dramatic. At Coronation, we know well that during the early stages of such a macro change, inertia towards recognising the trend can frustrate premature contrarian investments.

Put another way, it may well take another two to three years before rising nominal interest rates produce a real rate of return (after inflation) for passive investors. However, it is our belief that the era of disinflation that led to negative real interest rates is over. It is the interference of central banks (by buying public sector debt) that is preventing markets from pricing capital, and thereby distorting risk and financial asset allocation. Without this temporary and artificial support, the transformation of the global economy and financial system would have already become more apparent.

Therefore, while near-term conditions favour a period of growth in 2017 that is likely to last into 2019, we foresee this fading quickly in the 2020s as the economic, financial and political environment will begin to deteriorate across most of Europe and North Asia. Collectively, the common thread is likely to be a steady contraction in the global pool of mobile capital. This will result in the cost of capital becoming increasingly unaffordable for those countries failing to manage their economies in a prudent and productive manner. South Africa will be particularly vulnerable to this trend.

With regard to global equity markets, the valuation of the US market is the benchmark from which investors generally take guidance. There is little doubt that US equities appear overpriced – especially when measured against long-term averages. Additionally, a recent survey undertaken by Bank of America indicates that over 80% of participants believed that the US equity market looks expensive. A measure that is often turned to when seeking valuation guidance is the cyclically adjusted Shiller Index. This index is the S&P 500 price-to-earnings ratio based on average earnings over the past 10 years. This index is now well above the very long-term average of 16.7 times – currently standing at 29.7 times.

While this undoubtedly high valuation calls for caution, it is worth pointing out that this has been the case for a number of years in the severe post-2008 equity bear market. Additionally, statistical studies have shown that historically, the Shiller Index has only explained around 10% of market movements over any subsequent five-year period. As we well know, we operate in very unusual times at present, when assessed in terms of ease of forecasting. Many fundamental demographic and social changes are currently unfolding, which make forecasting problematic. It is a time during which investors who draw on their ability to apply much-needed perspective and calm will navigate the uncertainty successfully. ■

FACTFILE

CORONATION HOUSEVIEW EQUITY

SUPERIOR, CONSISTENT RETURNS OVER THE LONG TERM

INCEPTION DATE
October 1993
PORTFOLIO MANAGERS
Karl Leinberger, Sarah-Jane Alexander and Adrian Zetler. Karl has managed the Coronation Houseview Equity Strategy since 2005. Sarah-Jane joined Coronation in 2008 and manages assets within the strategy. Adrian is co-manager and joined Coronation in 2009.

OVERVIEW

Coronation Houseview Equity is our flagship specialist South African equity strategy. Launched in 1993, it boasts a compelling track record of almost 24 years of material outperformance of the South African equity market. Having recently been re-opened to new investors after a five-year closure (read more in the article on page 14), we are pleased that this offers more of our institutional clients the opportunity to share in this strong performance.

MANDATE

Coronation Houseview Equity represents our best investment view for an equity mandate. The portfolio is constructed on a clean-slate basis with no reference to a benchmark. As such, we seek to identify the most compelling risk-adjusted returns in the South African market with the aim of outperforming the equity market over meaningful periods (defined as at least five years). Our aim is to replicate the outperformance of the market that this strategy has achieved historically.

PORTFOLIO CONSTRUCTION

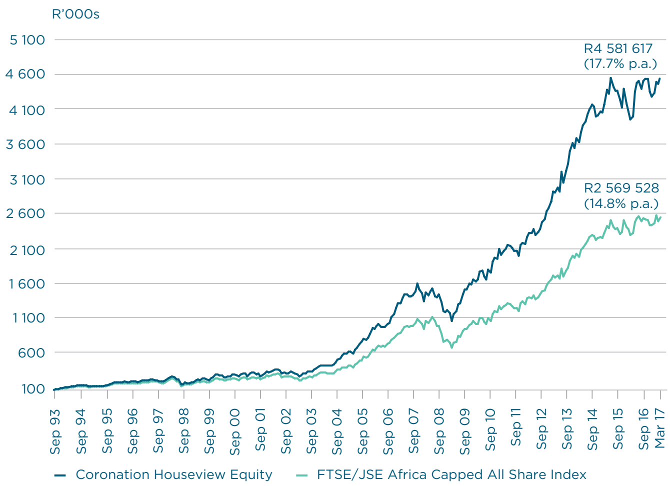
Coronation is a long-term, valuation-driven investment house. Our aim is to identify mispriced assets trading at discounts to their long-term underlying value (fair value) through extensive proprietary research. Coronation Houseview Equity comprises the strongest conviction ideas from our research process – and therefore our view of the most undervalued listed shares in South Africa, given our long investment horizon.

We do not define risk as volatility, tracking error or divergence from a benchmark but rather as the probability of a permanent loss of capital. Across all of our mandates, we consistently aim to construct robust, antifragile strategies that are sufficiently diversified across our highest conviction investment ideas. We believe that a diversified portfolio of undervalued assets is the best protection an investor has in an uncertain world.

COMPELLING TRACK RECORD

Coronation Houseview Equity has delivered a return of 17.7% per annum since inception almost a quarter of a century ago, outperforming its benchmark by 2.9% per annum during this time. This track record has been produced during various market cycles and periods of unprecedented macro volatility.

GROWTH OF R100 000 INVESTED SINCE INCEPTION*



Source: Coronation

A defining feature is the consistency and persistency of the long-term alpha produced, unusual by local and global standards. We believe this is the result of a disciplined focus on investing only in businesses that are trading at a discount to our assessment of their real long-term value. ■

* The performance shown here is for informational purposes only and is meant to demonstrate the performance of Coronation's longest running strategy. The Houseview Equity Strategy is not marketed to US investors and the performance shown here is not indicative of performance that would have been achieved in any other Coronation strategy, including those marketed to US investors. Investors should carefully review the materials and disclosures for the strategies they are interested in. The performance shown is gross of fees. Past performance is no guarantee of future results. Inherent in any investment is the potential for loss. The volatility of the FTSE/JSE Africa Capped All Share Index (CAPI) represented above may be materially different from that of the Houseview Equity Strategy. In addition, the holdings in the accounts comprising the Houseview Equity Strategy may differ significantly from the securities that comprise CAPI. The CAPI has not been selected to represent an appropriate benchmark to compare the Houseview Equity Strategy's performance, but rather is disclosed to allow for comparison of the strategy's performance to that of a well-known and widely recognized index. The CAPI is constructed in the same way as the JSE All Share Index but constituents with a weight larger than 10% are capped at 10% at each quarterly review.