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The Global Quarterly

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JANUARY 2019 SUMMER EDITION

CORONATION
TRUST IS EARNED™

Kirshni on point

2018 in review

AS YEARS GO, it's safe to say that 2018 is right up there with some of the roughest we have seen. But it was also a year in which Coronation turned 25. Such a milestone birthday is naturally a good time to reflect on how far you have come, where you find yourself, and where you are headed.

It's clear that, while we have operated through years of immense change since launching in 1993, our singular focus on our clients and delivering long-term investment outperformance and service excellence has always remained constant. Starting with no assets and no clients, we have grown to become a significant, independent South African asset manager.

It is our compelling long-term track record, steadfastness and experience that gives us the solid foundation to withstand years like 2018. It was a dismal one for investors globally, with price declines in most asset classes. Treasury bills beat the returns of almost every major asset class last year. To put the returns into context, Goldman Sachs shows that, over the last century, there have only been three other periods in which treasuries have had such outperformance: when the US hiked interest rates to 20% in the early 1980s, during the Great Depression, and at the start of the First World War.

Kirshni Totaram 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.

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LIFE BEYOND RAMAPHORIA

For the South African economy and markets, it's been the worst year since the dawn of our new democracy. The FTSE/JSE All Share Index ended the year down 8.5% and the rand weakened by 13.8% against the US dollar.

Many South Africans started out hopeful for a post-Zuma recovery under new President Cyril Ramaphosa. But growth continued to disappoint and instability in the Treasury continued. The current account deficit widened, the mining sector contracted, and manufacturing output was weak. The agricultural sector, which was already under pressure due to rand weakness, land reform and food price inflation, was hit hard by the prolonged drought. Thank goodness for those winter rains we saw in Cape Town, which brought some welcome relief and a slight extension to the now globally infamous two-minute shower.

Hard truths also rained down at the Zondo Commission, revealing the depth and cost of corruption at the highest levels of business and government. All of this, along with a disturbingly high unemployment rate of 27.5%, put South Africans under immense strain last year. When the day-to-day gets tough, it's so much harder for people to save. This pressure has impacted the long-term savings environment. Read more about the South African economy in Coronation economist Marie Antelme's review on page 24.

I don't see an easy path forward, but I was encouraged to hear finance minister Tito Mboweni's plans for remedial actions in his 2018 Medium-Term Budget Policy Statement. Moves against corruption by revisiting the state wage bill, the size of Cabinet, and the financing of failing state-owned institutions will be a significant step towards restoring consumer and investor trust in South Africa.

And not to mention that it's almost time for the Default Pension Regulations – an ecosystem of advice, counselling and annuity strategies. After two years of planning, we will now start to see the impact of this change on the South African savings landscape.

THE GLOBAL ENVIRONMENT

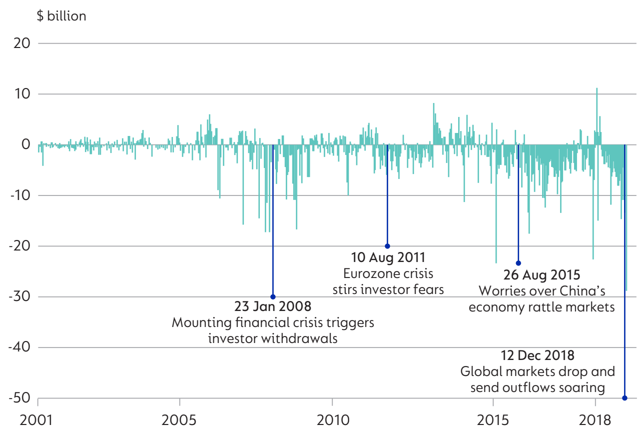
If ever there was a year to provide endless global topics for conversation, it was 2018! The list goes on and on – from Trump and his trade wars to the volatile year in tech; from the arduous path to Brexit to rising global populism and a busy election year for many countries. How will we forget the meme-fuelling moments such as Mark Zuckerberg's US senate hearing and Elon Musk's erratic behaviour? But we also saw rising political tensions often escalated by single events such as the murder of Saudi journalist Jamal Khashoggi in Instanbul.

The news was not all bad, or fake. In 2018, North and South Korea vowed formally to end the Korean War and they symbolically marched under one flag at the Winter Olympics. In the US, the first Muslim and Native American women were elected to Congress, and in Saudi Arabia, women were finally allowed to drive. Further afield, NASA's InSight touched down on Mars and captured the first sounds of wind on our neighbouring planet. Back on earth, we had our own headwinds to deal with. Global growth slowed at the start of 2018, stalling momentum built through 2017, mainly due to increased trade tensions and rising debt levels. Developed markets were down 9.4% for the year as measured by the MSCI All Country World Index in US dollars. Market losses were the most brutal over the last quarter, with December wildly volatile, especially in the US. Marie Antelme provides in-depth analysis in her global economic review on page 18.

THE MARKETS HAVE A NEW RHYTHM

Active managers have had a torrid time in the market for the past few years. It is impossible to attribute out the large number of drivers and triggers to both the market returns and the lower returns seen by many active managers, but markets appear vulnerable to abrupt dislocations at present. As a consequence, active funds have seen material outflows, with a record amount in December 2018.

WEEKLY FLOWS



Sources: EPFR, Financial Times

We also cannot ignore that we have seen a change in the rhythm or tempo of the markets. How much of this is driven by the prevalence of 'algos' or quant-like strategies is difficult to determine, but the impact is certainly not inconsequential.

Today, prices move sharply on the back of very little fundamental news (sometimes none at all). On more than one occasion over the past year, our dealing room has shown me charts that indicate the time from a Bloomberg alert to first material share price moves being in the order of 11 seconds. No human can do that. So I certainly believe that markets are evolving – as they have done numerous times in history. In fact, it is estimated that quant strategies and high-frequency traders account for more than 50% of US equity trade.

All of this adds to the short-term noise in the market. It has also driven a more short-term-focused investor mindset. We believe that for those who have the courage to stick to a long-term, valuation-driven investment approach, material opportunities are created.

OUR PERFORMANCE

Our longer-term performance remains excellent, but we experienced bruising short-term underperformance in certain strategies in 2018. Our Fixed Interest and Frontier Markets strategies had a remarkable 12-month period, but our South African Equity, Global Emerging Markets Equity and Multi-Asset portfolios fared less well. We never expect return patterns to move in a straight line only and have always understood that these periods of underperformance occur regularly for active managers. But it's always painful to experience. History is no predictor of the future, but lessons can and are being learnt. We are working hard to rectify this, and I sincerely appreciate the confidence our clients have in us in trusting our investment philosophy in the face of short-term challenges. We remain singularly focused on delivering long-term performance. Our CIO Karl Leinberger reflects on this recent performance within our South African portfolios on page 6 and Gavin Joubert on our Global Emerging Markets portfolio on page 10. Both reiterate our commitment to our tried and tested investment approach.

With increased investment in our infrastructure, technology and people over the past year to support the provision of excellent service, we are confident that we will continue to deliver sustainable long-term value to our clients. And it is always worth noting that this philosophy has worked well for investors historically. Since launching our global franchise more than 10 years ago, we have established a world-class track record in our specialist Emerging and Frontier Market strategies. This expertise was lauded in 2018 when Coronation was named Best Africa Fund Manager for the third consecutive year in the Africa investor Institutional Investment and Capital Market Awards.

IMPLEMENTING OUR NEW ADMINISTRATION MODEL

In July, we successfully completed the transfer of the asset administration of our domestic strategies to JP Morgan. This consolidates our asset administration service across local and offshore portfolios, enhancing our ability to offer our clients world-class service. Thank you for your patience during this significant change.

SUPPORTING BLACK BUSINESSES IN FINANCIAL SERVICES

We also dedicated considerable resources in terms of both people and technology to establish Intembeko Investment Administration (IntIA), one of the first black-owned and -managed transfer agency service providers in South Africa. I believe the result will not only be a great experience for our clients but also the achievement of the objectives of B-BBEE through the distribution of InTIA profits to black beneficiaries, once again reaffirming our 25-year journey of achieving meaningful transformation in the South African financial services sector.

CORPORATE CITIZENSHIP

At Coronation, our focus is on the long term in everything that we do, and we take our role as an influential corporate citizen seriously. As a manager of people's long-term savings, we think beyond our generation and consider the long-term impact of our actions on our clients and stakeholders, the wider community and the environment.

Investing responsibly and consciously is critical to us. We continue to strengthen the incorporation of environmental, social and governance (ESG) factors in our investment processes in a way that is fully in line with our clients' long-term investment horizon.

In response to corporate governance failures, highlighted by, but not limited to, Steinhoff, we have supported the move to audit firm rotation, and we continue to deepen our company analysis and increase our scrutiny of the potential for 'bad actor' business leaders. For more on some aspects of our approach to responsible investing, read Coronation Portfolio Manager Pallavi Ambekar's article on page 15.

CONCLUSION

Lessons learned

After a humbling year for the markets and our business, we have reflected intensely on what we have learned and what we could do better. I have great faith in our people – their integrity, intelligence, skills, experience and determined spirit. These attributes have successfully sustained Coronation over our 25 years and will continue to do so.

More than ever, I value the trait of curiosity in each of us. A recent *Harvard Business Review* featured the importance for curiosity in business. Encouraging it at all levels helps us to adapt to uncertain market conditions and external pressures, and think even more deeply and rationally about the steps ahead. We have learned many lessons this year, and exercising enhanced scepticism has become critical in response to events such as corporate governance failures.

Looking ahead to the next 25 years

While 2018 has been tough, the good news is that the outlook and potential returns from this point on are more positive.

We remain firmly committed to our long-term investment philosophy, which is the cornerstone of our business. While periods of short-term underperformance may be uncomfortable and testing, we have endured them many times throughout our history in building our compelling long-term investment track record.

We are cautiously optimistic about return opportunities reflected across our portfolios, all of which are underpinned by extremely compelling valuations. Markets like these test our pain thresholds significantly and investors are often tempted to switch into safer assets. But history has shown these to be the wrong times to do so.

I want to sincerely thank all our clients for your continued support. We remain committed to earning your trust and delivering on our purpose of growing your savings portfolio meaningfully over time. I wish you a happy, healthy and prosperous 2019. ✚

Kirshni

Taking stock

Reflecting on a tough year

By Karl Leinberger

2018 WAS A bruising year for us, with many of our strategies underperforming the already anaemic market benchmarks. I used my December break, away from the mania that is financial markets, to reflect on lessons learned, the defining positions in our strategies and how this most recent cycle compares to previous cycles I have lived through in my 19 years at Coronation.

RECENT UNDERPERFORMANCE IN THE LONG-TERM CONTEXT

We have been here before – painful periods of underperformance have been a regular feature of our long-term track record.

Our last period of acute underperformance serves as an excellent case study in this analysis. Three years ago, in the late stages of the commodity bear market, in a piece to clients on long-term investing, I made the following comment: “The graphs ... show how misleading short-term alpha is. Notwithstanding consistent and compelling delivery on a long-term cumulative basis, our portfolios have underperformed the market in one out of three years. However, in every one of those periods, the portfolio actions that caused short-term pain (buying dramatically undervalued assets that were falling, while selling overvalued assets that were

Karl is Chief Investment Officer (CIO) and manager of Coronation’s Houseview strategies. He joined Coronation in 2000 as an equity analyst, was made head of research in 2005 and became CIO in 2008. Karl has 19 years’ investment experience.

rising) were the very same actions that delivered compelling results when the cycle (subsequently) turned."

In the three years since, this argument has been strongly vindicated. Commodity stocks were widely loathed at the time and our overweight position had, until that point, been very costly. In the article, I referred to Anglo American moving from $10 to $70 through the bull market, only to collapse to an absurdly low $3.50 at the time of writing. A week after writing, the cycle turned (if only we had known then that we were at the bottom of the market!). Anglo is up an eye-watering seven times in the three years since.

The piece included an analysis of alpha in our flagship Houseview Equity strategy over the full period of our history as an investment firm. This has been updated appropriately in the accompanying graphs and table, and merits the following observations:

- *Short-term alpha*. Although it does not feel like it, the data show that this cycle to have been fairly mild compared to some of the seven other downcycles we have lived through over the years.
- Long-term alpha. Our long-term track record remains compelling in what has been a very challenging 25-year period in which to manage retirement capital – characterised by notable events such as the transition to democracy, emerging markets crises, currency collapses, the Global Financial Crisis (GFC) and more recently, Nenegate, to name but a few.
- Medium-term alpha. The graphs show quite neatly how this cycle has differed from previous ones, in that our five-year alpha turned negative in 2018 for the first time in our 25-year history. Although five years fall short of a full business and investment cycle, it is an important and closely watched performance metric.

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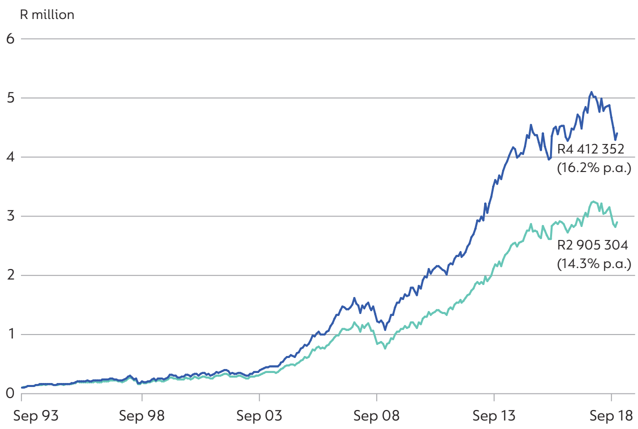
LONG-TERM ANNUALISED PERFORMANCE

Specialist South African equity strategy as at 31 December 2018



— Coronation Houseview Equity — Benchmark

Benchmark: FTSE/JSE SWIX; FTSE/JSE Capped SWIX from 1 December 2016

Note: Performance is gross of fees (management and performance) and expenses in ZAR. It includes re-investment of dividends.

Sources: Coronation, IRESS

All graphs and strategy returns are for illustration purposes only. This strategy is only marketed to South African institutional clients.

COMPOUNDING: THE MOST POWERFUL FORCE IN THE UNIVERSE

1.9% alpha takes a 29-bagger to a 44-bagger over 25 years

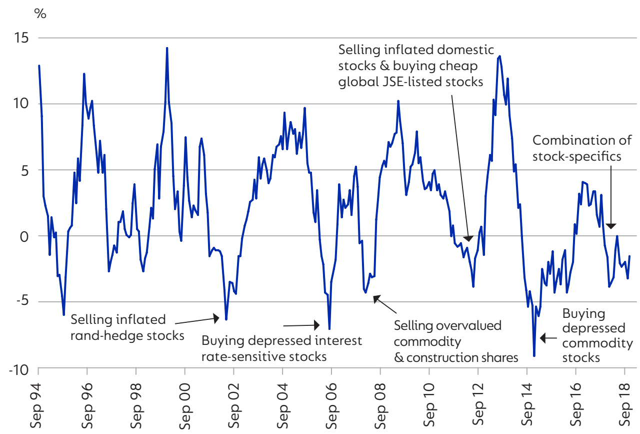
	Coronation Houseview Equity Portfolio	FTSE/JSE Capped SWIX**	Alpha
Since inception*	16.2%	14.3%	1.9%
20 years	17.0%	15.1%	1.9%
10 years	13.5%	12.7%	0.8%
5 years	3.6%	5.3%	(1.7%)
3 years	2.7%	2.7%	(0.1%)
1 year	(12.5%)	(10.9%)	(1.5%)

* September 1993
** Benchmark: FTSE/JSE SWIX; FTSE/JSE Capped SWIX from 1 December 2016
Note: Performance is gross of fees (management and performance) and expenses in ZAR. It includes re-investment of dividends.

Sources: Coronation, IRESS

SHORT-TERM ALPHA IS LUMPY

A successful track record comes with testing years



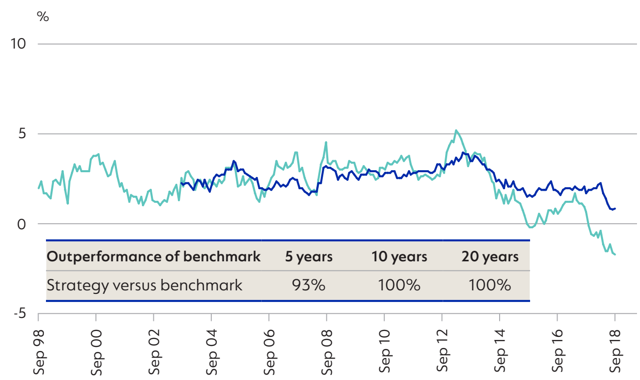
— Coronation Houseview Equity portfolio: 1-year rolling alpha

As at 31 December 2018
Benchmark: FTSE/JSE SWIX; FTSE/JSE Capped SWIX from 1 December 2016

Sources: Coronation, IRESS

ALPHA OVER MEANINGFUL PERIODS

It is over the long term that we measure results



Outperformance of benchmark	5 years	10 years	20 years
Strategy versus benchmark	93%	100%	100%

— Coronation Houseview Equity portfolio: 5-year alpha
— Coronation Houseview Equity portfolio: 10-year alpha

As at 31 December 2018

Sources: Coronation, IRESS

WHY HAS THIS PARTICULAR PERFORMANCE CYCLE BEEN SO TOUGH?

Previous periods of Coronation underperformance were largely due to a single cycle playing itself out (examples include the currency blowout in 2001, the interest rate cycle in 2006, the commodity cycles in 2008/2016 and the GFC in 2008/2009).

This time around, things are a little different, with a combination of several meaningful but unrelated positions in out-of-favour asset classes and stocks all detracting in the same period (despite very different fundamentals).

Key detractors include:

- Asset classes: overweights in local equities, emerging market equities and high-quality property stocks.
- Stock-specifics: large positions in British American Tobacco, Northam Platinum, MTN, Intu, Hammerson, Anheuser-Busch InBev and Quilter.

NOTHING HAS CHANGED

We strongly believe that nothing has changed for us. The investment philosophy and process that have delivered through many performance cycles for two-and-a-half decades remain unchanged.

It is a process that has delivered an exemplary long-term track record across multiple asset classes and geographies (local equities, fixed income, asset allocation funds, emerging market equities and frontier markets).

The same people, working harder than ever, are managing your money and doing the hard yards in our research effort (albeit with a few more scars on our backs!). We remain intellectually curious, relentlessly searching for a deeper understanding of the world in which we invest your capital. For example, during the course of last year we had more than 35 calls with various stakeholders in the tobacco industry to try to better understand an industry undergoing dramatic change.

Finally, we remain flexible and determined not to fall into the trap of being stubborn. In this industry, if you do not have the humility to know that you live in an uncertain and unforecastable world, you will fail. We have an internal culture of championing minority views and challenging groupthink. Where we think we have made a mistake, we have either sold or reduced position sizes. Where we do not believe this to have been the case, we have either held our position or bought more at lower prices.

KEEPING THE FAITH

We are perplexed by the prices at which some stocks currently trade. The value we are finding in certain stocks is simply astounding.

Our view is that changes in market structure have driven a dislocation in the pricing of stocks. Anything with a whiff of value has been slaughtered – and with no apparent valuation floor. Much of this is likely a consequence of the global megatrend: out of value managers into high-quality (or 'Growth at a Reasonable Price') managers, into quant funds and, finally, away from active to passive funds. Although this is currently a source of great frustration, it is also an opportunity for the patient, long-term investor, given the fact that the fundamentals always ultimately assert themselves.

The performance cycle is part and parcel of managing money for the long term. Investing is fundamentally a non-linear activity and, in order to secure long-term gain, one needs to be prepared to endure short-term pain.

Although there are many investors who endeavour to deliver steady results in what is a random, inefficient and volatile market, I believe this to be an impossible task over long periods of time and analogous to the efforts of Isaac Newton, one of the great minds of all time, who expended an enormous amount of energy practising alchemy before ultimately failing.

History has shown, over and over again, that cycles always turn and that the surest path to wealth creation lies in long-term investing. Only this time horizon gives one the mandate one needs to fully exploit the inevitable differences between price and value.

SOME GOOD NEWS – LOOKING FORWARD

At a time when many are running for the safety of cash, we are more sanguine about the future.

- After being very negative about the South African equity market for most of the last five years, we are now much more optimistic about future returns:
  - We have taken advantage of depressed sentiment to significantly increase the quality of our Houseview Equity strategy (currently very high quality stocks comprise an abnormally high 57% of the portfolio).
  - We currently find an unusual confluence of value in the local market, both in the rand hedges (examples include British American Tobacco, Quilter and Anheuser-Busch InBev) and in domestic stocks. There are many examples of high-quality, defensive stocks that have endured a tough operating environment over the last few years and have low earnings bases. Many of these should see strong earnings recoveries if the economy recovers at all from a very depressed base. Examples include Pick n Pay, Spar, Netcare, Famous Brands and Afrox.
- We believe that some of the high-quality domestic property stocks offer value, notwithstanding the likelihood of an Edcon bankruptcy at some stage this year.
- Many emerging markets are very cheap after a miserable few years. It has been many years since we have been able to buy high-quality businesses at the undemanding ratings currently available in many of these markets.

Although there are no guarantees in life, and low prices do not guarantee high future returns, they certainly provide fertile ground in the search for above-average, risk-adjusted returns.

I conclude with an apt quote from one of the great investors of our time, Seth Klarman:

“In investing, nothing is certain. The best investments we have ever made, that in retrospect seem like free money, seemed not at all that way when we made them. When the markets are dropping hard ... and an investment you believe is attractive, even compelling, keeps falling in price, you aren’t human if you aren’t scared that you have made a gigantic mistake. The challenge is to perform the fundamental analysis, understand the downside as well as the upside, remain rational when others become emotional, and don’t take advice from Mr. Market, who again and again is a wonderful creator of opportunities but whose advice should never, ever be followed.” ✚

Global emerging markets

Disappointing performance conceals attractive long-term prospects

By Gavin Joubert

Head of Global Emerging Markets, Gavin has close to 20 years' experience as an investment analyst and portfolio manager. He joined Coronation in 1999 and manages assets within the Global Emerging Markets Equity strategy.

VERY DISAPPOINTINGLY TO us and undoubtedly to investors, 2018 was the worst year by some way in our Global Emerging Markets strategy's 11-year history, underperforming the market by 10.7%, and we apologise for this very poor performance. The strategy's previous worst year was 2015 when we underperformed the market by 5.9%. Since inception in 2008, the strategy has outperformed the market in seven of the calendar years and underperformed in four (including 2018). In four of the seven years in which we outperformed the market, it was by a double-digit percentage. Because the strategy looks so different to the index (and many peers), with an average active share of 90% over the past 10 years, this type of outperformance (and unfortunately underperformance) does happen, as disappointing and uncomfortable as the latter is for us and for our investors. After a period of poor performance, we tend not to change the portfolio too much (as typically much of what we own has become more, not less, attractive) and strong performance periods usually follow.

With the strategy currently showing c. 80% weighted average upside to fair value at the end of December (compared with the long-term average of c. 50%), we are positive on the return prospects for the strategy.

In trying to analyse the reasons for the strategy's severe underperformance in 2018, there is no one clear factor. This is in contrast, for example, to 2015 when the underperformance was almost entirely due to Brazil, which was going through an unprecedented recession at that time. In the three years leading up to and including 2016, GDP per capita in Brazil contracted by 30% in US dollars. This is as severe as the Great Depression in the late 1920s/early 1930s, when US GDP per capita contracted by 28%.

To summarise the underperformance in 2018, the strategy somewhat unusually saw five disparate businesses among its top 15 positions decline by c. 50% in US dollars, for different reasons. At the same time, there were simply not enough winners to offset the impact. The five largest negative detractors for the year were Kroton (2.6% negative contribution), British American Tobacco (-1.7%), Magnit (-1.5%), Tata Motors (-1.3%) and JD.com (-0.9%). In total, these five stocks account for over 70% of the strategy's underperformance. On the positive side, Adidas (0.6% positive attribution), Airbus (+0.6%), Housing Development Finance Corporation (HDFC) (+0.4%) and Banorte (0.4%) contributed, but as mentioned, this was not sufficient to offset the impact of the negative contributors.

We have covered most of these five stocks in detail in various commentaries during the course of the last year, but given the extent to which they detracted from performance in 2018, it is worth providing a summary of what went wrong, as well as our current view on each share.

- *Kroton (the top private education operator in Brazil; 3.1% of strategy).* In our view, the sharp decline in the share price was due to a combination of disappointing earnings, concerns relating to its student base (with government-funded students graduating and being replaced by students funded by Kroton) and an expensive (at face value) acquisition to enter the K-12 market. We would agree that Kroton is experiencing challenges in the short term and faces a tough 2019 after experiencing a difficult 2018. However, we believe the long-term prospects remain very attractive (underpenetration of the tertiary education sector in Brazil, in what is a scale business in which Kroton is the no. 1 player, with an exceptional management team). Kroton trades on less than 10 times 2019 earnings, with a 3.5% dividend yield and c. 80% upside to fair value.

- *British American Tobacco (the second-largest global tobacco company; 4.0% of strategy).* The sharp share price decline was arguably due to a number of factors, the most important of which was a proposal by the US Food and Drug Administration to ban menthol cigarettes in the US (which make up c. 23% of British American Tobacco's earnings), as well as general concerns over the transition to alternative nicotine products, including e-cigarettes. In our view, and clearly very different to the consensus market view, the prospects for the global tobacco companies are better than they have been for many years. For the first time, these companies have credible alternative (much lower risk) products, which make these businesses more sustainable over the long term. On the proposed menthol ban in the US, there are still many hurdles to overcome before anything materialises, and this may take a long time. Additionally, in the event of an eventual menthol ban in the US, in our view British American Tobacco will retain a large percentage of its menthol smokers by switching them to alternative products. The share price is now at a seven-year low (and rating near a 20-year low) and trades on less than nine times 2019 earnings, with a dividend yield of 8% and c. 70% upside to our estimate of fair value.

- *Magnit (the second-largest food retailer in Russia; 3.7% of strategy).* Magnit was beset by poor operational performance (in large part due to underinvestment in its stores), as well as the resignation of its founder and CEO, Sergey Galitsky, who sold his 30% stake in the business at the time of his resignation in February 2018. Under the new CEO, Olga Naumova (who was largely responsible for the turnaround of Magnit's main competitor, X5 Retail, during her five years there) and a new board, a number of positive changes have taken place, including the accelerated refurbishment of stores, changes in the product mix and the introduction of a management incentive scheme. This has already started to reflect positively on the company's results, with an improvement in like-for-like sales. The two leaders in the Russian food retail market, Magnit and X5 Retail, both strategy holdings, only have c. 9% market share apiece (with no. 3 having only 3% market share), and we believe that they can roll out stores and grow market share for many years to come. Magnit trades on c. 13 times 2019 earnings, with a 3% dividend yield and over 100% upside to our estimate of fair value.

- *JD.com (the no. 2 e-commerce company in China, after Alibaba; 3.0% of strategy).* In our view, the share price decline was driven by three factors: an approximately 20% to 30% decline in all Chinese internet stocks, slightly poorer-than-expected operational performance from JD.com, and an allegation of rape against the CEO in the US (authorities in the US have subsequently decided not to prosecute due to a lack of evidence). In our view, JD.com has created a very strong e-commerce business over the past decade by building its own fulfilment infrastructure (replicating the Amazon model), which is sufficiently differentiated from Alibaba's to enable both companies to win in the fast-growing Chinese e-commerce market. (Alibaba is also a strategy holding, albeit a smaller position at 1.5%).

  Over the past five years, JD.com has increased its revenue from $11 billion to $65 billion, and in the process has taken its gross merchandise volume market share from c. 6% to 17%. The market cap of JD.com currently is c. $33 billion, meaning it trades on 0.5 times revenue. From a profitability point of view, the business swings in and out of profitability depending on the level of investment; however, on any normal operating profit (earnings before interest and taxes, EBIT) margin, we believe that the business is cheap. A few reference points underscore this view: Amazon's (more mature) US retail business delivers EBIT margins of close to 10%, while high street physical retailers achieve margins anywhere between 3% and

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20% (depending on the product being sold, with food at the low end and clothing at the high end). JD.com management targets a high single-digit EBIT margin. Given its current revenue (assuming no further revenue growth, even though JD.com should be able to grow its topline at c. 15% to 20% for many years) and assuming a 3% EBIT margin, JD.com trades on 20 times historic (2018) earnings. Its core marketplace margins are already 2%, so a 3% margin is very conservative and JD.com is very cheap in our view. Its upside to fair value is c. 150%.

- *Tata Motors (owner of Jaguar Land Rover; 0% of strategy).* This was a poor investment and a mistake in our view, and we sold out of the position during 2018. A combination of internal factors (including poor cost control measures and mediocre new product launches) and external factors (such as Brexit, EU emissions legislation and US-China trade wars) led to a sharp decline in profits. Given the very thin current margins, combined with high debt levels and an uncertain future, both in terms of alternative vehicles and Brexit (the UK represents 20% of sales, with a large part of the manufacturing base being in the UK), we felt that the risk/reward became unattractive and sold the position.

Of these five stocks, if one compares our earnings estimates at the beginning of 2018 to what the companies are likely to actually report for 2018, we overestimated earnings in two cases: Kroton and Tata Motors, with the latter having been sold. In Kroton's case, earnings are likely to be down c. 10% in 2018, yet the share price declined by c. 50%. In two of the cases (British American Tobacco and Magnit), our revenue and profit forecasts were largely in line. In the case of JD.com, our revenue forecasts were within 5% of what the company is likely to report for 2018, as is the profitability of the core marketplace business, but investment in the logistics business was larger than expected, depressing group profitability.

In summary, the share price declines have therefore largely come not from getting the earnings very wrong, but from a significant de-rating in four of the five stocks. Of course, one can argue that markets are forward looking and that these de-ratings were for valid reasons, but in our view they have gone way too far, given the current operational performance and, more importantly, the attractive long-term prospects for these companies.

FACTOR PERFORMANCE IN EQUITY MARKETS 2018

Universe	Valuation	Earnings	Price	Quality
Asia ex-Japan	(10.1%)	(5.2%)	(4.3%)	(4.2%)
Japan	(13.6%)	2.9%	(0.8%)	(10.5%)
Europe	(10.0%)	2.1%	(2.7%)	(0.8%)
US	(19.8%)	3.2%	5.5%	2.4%
Global emerging markets	**(8.3%)**	(5.6%)	**5.6%**	(4.6%)
Emerging markets ex-Asia	5.3%	(2.7%)	27.9%	(0.6%)
Global developed markets	(12.6%)	2.5%	0.0%	(1.3%)
World	**(11.7%)**	0.0%	**2.1%**	(3.4%)

Source: JP Morgan

As can be seen from the table below left, 2018 was a year in which valuation severely underperformed in all major equity markets and price (momentum) was notably the best-performing factor.

Coronation's investment philosophy (long-term, valuation-driven investing) is clearly in the 'valuation' camp as opposed to the 'price' camp. While this is not an excuse, the reality is that the significant flow of assets into passive investing, as well as the rise of quant funds and the increased use of algorithms generally have changed the structure of the market. Arguably, this has created dislocations and additional risks.

By some estimates, only 10% of the volume in US markets today, for example, is in the hands of long-term fundamental investors. The implication of this (which can arguably be seen in many stock examples) is that price discovery does not happen as it used to. 'It's in the price' does not seem to exist any more, and what is going up, keeps on going up – and what is going down, keeps on going down (the table below left supports this point). This arguably makes investing more challenging, particularly for investors who are not momentum orientated. Of a group of 135 emerging market funds that we would consider to be our peers, 106 underperformed the market (to varying degrees) in 2018. Similarly, and to illustrate the effect of passives and momentum, an equal-weighted custom index of the 20 largest stocks in the emerging markets index would have outperformed the index by a considerable 5% in 2018.

With volatility at above-average levels in emerging markets, we were more active than usual, having made six new buys of greater than 1% in the fourth quarter under review, totalling 8% of the strategy. Four of these new buys (Russian internet business Yandex, Melco Resorts, Pão de Açúcar, the largest food retailer in Brazil, and luxury goods company Kering) are companies that we have covered for years and that the strategy has owned in the past, while two of the buys are companies that we have not owned before (Latin American e-commerce platform MercadoLibre and HDFC Bank).

The new buys were not concentrated in any particular region (one stock in each of Brazil, China, India, Russia, and Latin America, and one global company). By industry, two of these companies fall within the technology (internet) sector, three are in the consumer sector and one is in the financial sector. In terms of other buying activity, we continued to add to the strategy's position in New Oriental Education (taking it from a 2.3% position at 30 September 2018 to a 3.4% position at 31 December 2018), as the share price continued to decline. We also increased the position size of HDFC (from 3.0% to 4.3% of strategy), as Indian financials declined due to concerns about stress in the system. We further increased the position in Wuliangye, the second-largest Chinese baijiu producer (from 1.2% to 2.0%).

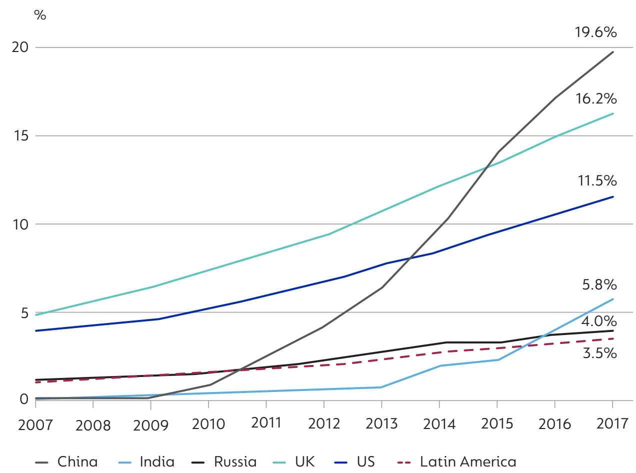
In terms of sells during the quarter, we sold out of three stocks – Chinese internet business NetEase and Visa (both largely on valuation), and Altaba (adding to existing positions in more attractive opportunities within the sector, namely 58.com and JD.com, and not wanting to further increase overall China internet exposure). The position in multinational technology company Baidu was also reduced for the same reason. In terms of geographic exposure, there were no material changes, with the only changes of more than 1% being an increase in China (from 25.3% to 27.3%, largely due to the activity mentioned above), an increase in India (from 11.2% to 13.5%, largely due to the additional buying of HDFC and the new HDFC Bank buy) and a decrease in developed markets exposure (from 23.2% to 20.3%, largely due to the poor performance of global tobacco stocks and a reduction in the Porsche position).

Yandex was the largest new buy (2.0% of strategy) during the quarter. We have covered Yandex for several years and have owned it before. The share price declined from a peak of $44 in February 2018 to its current levels in the mid-high $20s (partly due to Russia and partly due to the technology sell-off globally), bringing it into buying range. Yandex is the no. 1 search engine in what is an effective duopoly in Russian search, with the company having a market share of c. 57% and Google owning the balance.

We believe the prospects for search in general and for Yandex in particular are favourable (for example, low online ad penetration and Yandex taking mobile market share from Google) and that the search business alone is worth well north of the current share price. In addition, Yandex has net cash and a number of other smaller businesses that are currently growing revenue at a rapid rate (but that are still loss-making). While some of these businesses may never make money, there are a few that we believe have the potential to do so, including the taxi ride business (which is dominant after merging with Uber Russia and in which Yandex owns a 59% stake) and the e-commerce joint venture with Sberbank. Yandex trades on c. 20 times 2019 earnings (with profits depressed due to its investment in the various smaller businesses) and in our view is attractive at current levels.

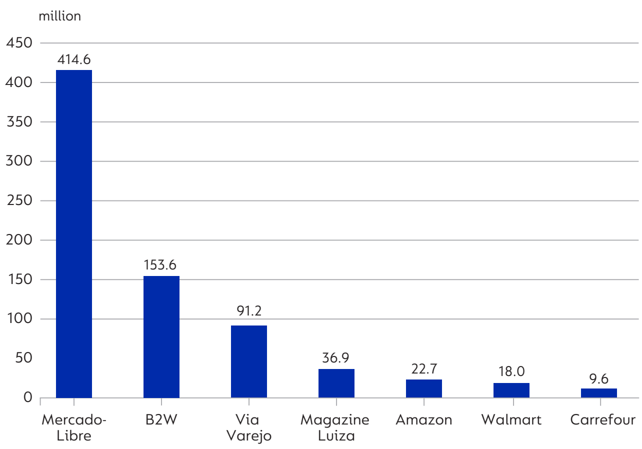
The other new technology (internet) buy was a 1.3% new position in MercadoLibre, the largest e-commerce platform (third-party marketplace) in Latin America. MercadoLibre has operations in 18 countries and holds a no. 1 position in 10 of them, including Brazil and Argentina, the two biggest contributors today. The company was founded 20 years ago; the CEO and founder, Marcos Galperin, still owns a meaningful stake (9%) in the business and continues to be very involved. MercadoLibre's revenue has grown

E-TAIL AS A PERCENTAGE OF SALES BY COUNTRY



Source: Euromonitor

TOP E-COMMERCE SITES IN BRAZIL BY VISITS



Source: Similarweb

by 31% per annum in US dollars over the past seven years and continues to grow at a high rate.

E-commerce penetration in Latin American is very low and MercadoLibre is the leader in Brazil (see the graphs below left and above right), which today contributes 70% of group earnings. Besides the e-commerce business, the long-term opportunity for the payments business (Pago) is also potentially significant, having only a 1% market share of card payments today. Profitability is well below normal in our view (EBIT margins of 9% currently versus a peak of 30%), and we believe MercadoLibre can grow both its topline and profits at a high rate for many years to come.

Melco Resorts and Entertainment is one of the casino operators in Macau that we have owned before but sold out of as it reached our estimate of fair value. The 45% decline in its share price in 2018, due to economic concerns over China and the Macau region, presented us with the opportunity to reintroduce Melco (1.4% position of strategy). Macau undoubtedly holds its own set of risks (as does any company in China and, indeed, in emerging markets in general), which include economic sensitivity and the regulatory

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MELCO CAPITAL ALLOCATION

US$ million	2014	2015	2016	2017	9m 2018	Total
Dividend	**178**	**385**	**734**	**198**	**209**	**1 704**
Regular	178	35	84	198	209	704
Special	-	350	650	-	-	1 000
Share buyback	**300**	**-**	**801**	**1 200**	**490**	**2 791**
Public	300				490	790
Crown Resort			801	1 200		2 001
Total	**478**	**385**	**1 535**	**1 398**	**699**	**4 495**
Market cap					7 648	
Capital return %	**6%**	**5%**	**20%**	**18%**	**9%**	**59%**

Source: Melco Resorts

environment, of which the upcoming gaming licence renewal is one. At the same time, the long-term prospects for Macau, not only as a gambling destination but also increasingly as a mass market holiday destination, remain attractive, with only a small percentage of the Chinese population having visited Macau.

Our attraction to Melco in particular (above the other five casino and hotel operators in Macau) is three-fold. First is its exposure to the mass market, which, along with Sands China, is the highest in the industry. In our view, a mass business is better than a VIP-focused business, as it is less cyclical and has a much larger potential market. Secondly, we are attracted to Melco's capital allocation. In this regard, the table on the previous page (over and above the company's c. 35% return on invested capital) shows the capital allocation of Melco over the past five years – 60% of Melco's market cap has been returned to shareholders in the past five years through dividends and share buy-backs. Importantly, the share buybacks have typically been done at attractive price levels. Lastly, Melco has the most attractive valuation of all the operators: a 2019 free cash flow yield of c. 11% versus 6% to 7% for the other five operators.

We have owned HDFC in the strategy for the past three years and today it is a 4.3% position. By owning HDFC, the strategy has indirectly owned HDFC Bank (as HDFC owns a 22% stake in HDFC Bank, which represents c. 35% of HDFC's value) but have never directly owned it, even though we have covered it for several years. The long-term fundamentals of the Indian financial services market are very attractive, in particular the low financial services penetration and the fact that the State banks (which are poorly managed and balance sheet constrained) still have 70% market share. This backdrop has formed a key part of our investment case for other Indian financials, which the strategy has and continues to own, including HDFC, Yes Bank and Indiabulls. HDFC Bank obviously also benefits from these tailwinds and, in addition to this, is arguably the highest-quality large bank in India, being the leader in digital, having the second-highest return on assets, the highest provision-coverage ratio, the lowest cost-to-income ratio and high retail exposure. This means that it is currently well placed to continue and even accelerate its market share gains, given the current troubles faced by a number of Indian banks. While the share has done very well over long periods of time, it has been flat over the past year, which, combined with improved prospects due to the current turmoil, made it attractive enough to warrant a 1% position.

The strategy's weighted average upside to fair value at the end of December was approaching 80%, well above its long-term average of c. 50% and close to the highest it has ever been. As such, and after a very disappointing year, today we are very positive on the prospects of the strategy going forward. ✚

Members of our Global Emerging Markets team continue to travel extensively to enhance our understanding of the businesses we own in the strategy, their competitors and the countries in which they operate, as well as to find potential new ideas. In this regard, over the past two years we have done detailed work (modelling, fair value assessments and research) on 57 new companies, 17 of which have made it into the portfolio over this period, representing 33% of the strategy today. In the fourth quarter, there were three trips to China, one to India and one to Brazil. The coming months will see a further two China trips (including one trip specifically focusing on the baijiu industry) and two trips to India.

Engaging responsibly

Responsible investing involves constructive, behind-the-scenes communication

By Pallavi Ambekar

Pallavi is co-portfolio manager of Coronation's Absolute Return strategies. She joined Coronation in 2003 as an investment analyst and has 16 years of investment industry experience.

RESPONSIBLE INVESTING HAS risen in prominence over the last few years as companies, investors and asset managers have had to respond to and deal with the investment impact from ethical and governance lapses, environmental challenges and social pressures. Integrating an assessment of environmental, social and governance (ESG) factors into the investment process has now become standard operating procedure. The manner in which ESG is built into the process can, however, differ significantly across the industry.

At Coronation, we believe the evaluation of ESG should be handled within the investment team who has a better understanding of the complex issues that underpin each individual company. As each potential investee company operates in different industries and geographies, there is no overall generic checklist of factors that can be uniformly applied. While we do subscribe to the services of 'specialist' ESG research providers and

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consider their views, the intricacies of each investment also mean that it is inappropriate to outsource this function.

As long-term investors, we have always explicitly identified and factored in the impact of environmental and social issues on the long-term health of the business and its various stakeholders. In addition, we strive to ensure that the companies we are invested in maintain high standards of corporate governance. Responsible investing is a dynamic environment, and our ESG process has been enhanced and adapted over the years as we have taken learnings on board. Recently it has been tightened to include additional governance requirements involving mandatory audit firm rotation every 10 years and increased scrutiny of the tenure and capability of directors.

As the emphasis on responsible investing has increased, we have responded through greater engagement with management and directors of investee companies. Our engagement process focuses on the most material issues that a company must address and can be broken down into two main categories:

- A continuous engagement on ESG issues that are unresolved and can have a material impact on the investment case. Examples of this would be pending new carbon tax legislation, outstanding legal claims relating to health and safety risks, and changing environmental regulations. These engagements allow us to quantify the impact of uncertain variables on our valuation, which assists us to make informed investment decisions based on robust valuations.
- A continuous engagement on ESG issues that relate to the stewardship of the company. This will commonly involve discus-sions relating to capital allocation strategy, the composition of the board in terms of skills and diversity, and the adequacy of key performance indicators and targets in setting the remuneration policy for senior management. In addition, as investors with a long-term time horizon, we think it is important to understand what companies are doing to protect the sustainability of their business and the environment in which they operate.

Our engagement process involves discussions on several topics, including but not limited to waste management, health and safety processes, and labour relations. This helps us to assess whether the company has a coherent strategy to deal with the environmental and social impact of its everyday operations. A company's awareness of these affairs and its willingness to address them in a formal, proactive manner indicate that the business is committed to be a good corporate citizen and to protect its sustainable long-term value.

The issues that we engage on are often complex and require that we have multiple discussions with the relevant companies. Our ultimate intention is to drive the change we feel will be most beneficial for shareholders in the long run. We find that a strategy of constructive, behind-the-scenes engagement directly with a company is far more productive than debating issues at a public annual general meeting (AGM) or through the press. Conversely, a strategy of merely selling out of companies without any engagement does not address societal needs and merely shifts the burden elsewhere.

ESG issues can often be resolved in direct meetings with a company's senior management team. Where appropriate, we escalate issues by writing a letter to the board of directors, setting out our key concerns. In addition, we also engage with fellow shareholders to apply more pressure for change.

If these actions still do not result in the desired outcome, we will take the appropriate steps at either the AGM or call a special meeting to highlight our grievances and make the necessary recommendations. If our best efforts are unsuccessful, we will reassess our investment case and valuation and take the appropriate investment action in our portfolios. All our interactions are fully documented in a central ESG database which records the relevant issue, the company's response and how the issue was resolved.

Below we have included three examples of issues that we have engaged on in the past.

ESG ISSUE: CAPITAL ALLOCATION

Sector: South African resources company

Brief details
Since 2012, we had numerous engagements with and wrote two letters to the board of a listed resources company to discuss its capital allocation strategy. We highlighted that the company's track record of past acquisitions and investments had not created value for shareholders. We encouraged the company to consider using higher hurdle rates when embarking on future investments to mitigate execution risk. We also suggested that new capital projects should be assessed against the value created from returning cash to shareholders via increased dividends or buybacks.

Outcome
Following the initiation of our engagement process in 2012, the board of directors took note of our suggestions and in late 2017 announced a new capital allocation framework to the market. This new framework presented a medium-term focus on strengthening the company balance sheet while improving the dividend payout ratio. Once the balance sheet had been returned to a healthy state, the company would evaluate small- to medium-sized growth options and further increase the dividend payout ratio. We felt this revised capital allocation framework was properly constructed and balanced the need for the company to continue to invest in a considered manner as well as improve returns to shareholders.

ESG ISSUE: EMPOWERMENT DEAL

Sector: South African resources company

Brief details
To comply with the provisions of the Mining Charter in force at the time, a resources company was required to enter into a black economic empowerment (BEE) deal to replace a previous transaction that had ceased to exist. As significant shareholders, we engaged extensively with company management and external advisers over a period of approximately six months to shape a

deal with an innovative funding structure that achieved genuine broad-based empowerment while at the same time addressing the concerns of potential dilution for existing shareholders.

Outcome

A deal was concluded that resulted in the raising of significant capital for the company's expansion plans funded through a high-yielding tradeable instrument, making it attractive to investors. The resulting BEE ownership comfortably exceeds the minimum requirements. More importantly, the deal incorporates a significant allocation (75% of the deal) to employees, surrounding communities, women's groups and historically disadvantaged organisations. We ensured that long-term incentives were created to align management with the objectives of the transaction and we continue to engage on issues such as board representation of BEE participants.

ESG ISSUE: CORPORATE RESTRUCTURE

Sector: South African listed property company

Brief details

A property company was listed as a property unit trust (PUT). While this is allowed by the JSE, it significantly limits the ability of shareholders to influence the governance of the company, and as a result the company failed to attract meaningful shareholding on the JSE. The essence of a PUT structure is that the fund is managed under the Collective Investment Schemes Control Act guidelines, with unit holders having no say in the governance of the vehicle, while the fund manager is outside the listed vehicle. Through extensive engagement with the company itself and its ultimate controlling shareholder, we reached an agreement whereby the PUT structure would be converted into a real estate investment trust (REIT), allowing better governance via requiring normal shareholder meetings and AGMs. In addition, the company internalised its management company and the holding company chose to cancel its greenfield put option to place properties into the structure.

Outcome

The restructuring of the company from a PUT to a REIT resulted in a significantly more investable company, with appropriate levels of governance and control in place. A more sustainable company structure should provide for greater returns over time.

CONCLUSION

The examples above highlight that the ESG engagement process involves sincere communication with the company, usually taking place over multiple instances to help us shape the outcome that is most value enhancing for shareholders. We believe this understated approach is far more constructive than airing the issues in a public forum for the sake of a few headlines. Our aim is to resolve these matters in a way that leads to more sustainable and better corporate behaviour. This, we believe, is one of the ultimate aims of responsible investing. ✚

What a year it was!

The way in which financial markets respond to US rate expectations is important

By Marie Antelme

AGGREGATE GLOBAL GROWTH is expected to be 3.7% in 2019, above potential for the second consecutive year. The strong growth performance has seen unemployment in most developed economies fall to multi-decade lows. Subsequently, tight labour markets have put pressure on wages and inflation has started to rise. An increasing number of countries have inflation running ahead of their central bank targets, prompting a general, if uneven, normalisation in global monetary accommodation in developed economies. However, the way in which this unfolded was far from smooth, especially for financial markets, and the outlook remains highly uncertain.

In recent weeks there has been a significant shift in the way in which financial markets are pricing growth and policy settings, especially in the US. Following a year in which the US led the growth outperformance, the duration of the upswing, as well as

Marie is an economist with 18 years' experience in financial markets. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

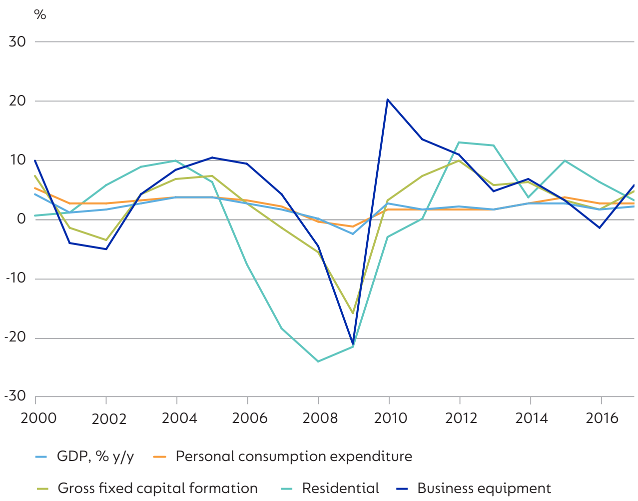
the combined weight of escalating trade tensions and weakness in other economies, has seen weaker data emerge. Financial markets have slowed, and with a significant adjustment in US equity markets, no further US Federal Reserve (Fed) rate hikes are expected for the coming year.

Because US policy rates influence global funding costs, the way in which financial markets respond to US rate expectations is important. For now, we think the recent adjustment is overdone. Market concerns about a US recession have been heightened by a flattening in the US yield curve, but additional signposts for a pending recession in the US are visibly absent. There are certain signs of slowing, but abject weakness seems unlikely.

PAST RECESSION SIGNPOSTS

A closer look at past recessions offers some good guidance in assessing current risk. The first thing to note is that US recessions are always driven by domestic demand. External economic dynamics, including the global manufacturing cycle, have not to date driven a growth contraction in the US. And typically, domestic demand in the US shows several consecutive quarters of subtrend weakness before contracting. The graph below indicates that the main components of domestic demand are still growing strongly.

US GDP BREAKDOWN, LONG-TERM



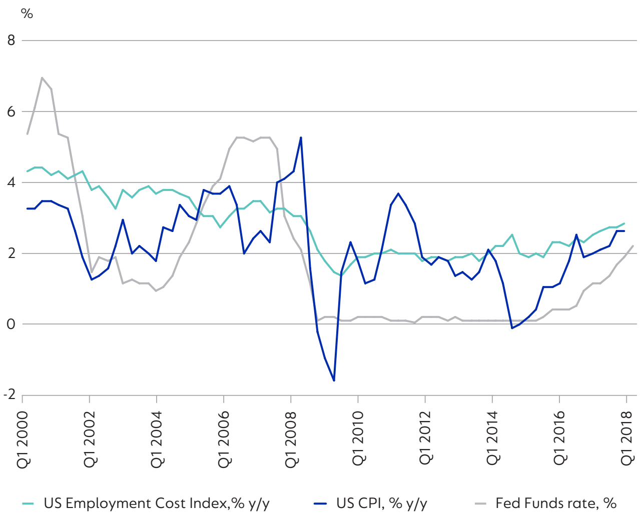
Source: Datastream

US recessions also broadly tend to follow a pattern: a sharp slowing in capital formation, which usually takes the form of a collapse in residential housing investment, followed by falling consumption expenditure and a collapse in business investment. This is not always the case, but when a collapse in business investment comes early, it is usually accompanied by weakness in household investment and outlay. To date we have not yet seen even one quarter of real weakness across any of these factors.

Another characteristic of past recessions has been the buildup of excesses; again, often in housing or business investment. Excessive housing inventory accumulation undoubtedly aggravated the recession in the US between 2008 and 2010. These inventories also delayed the recovery and contributed to the muted growth in housing activity through this expansion. That said, despite the softness in the housing market due to rising interest rates, there is more scope for it to become a point of resilience in the current environment (very low employment and excess demand) than a source of vulnerability.

Household spending accounts for almost 70% of real GDP in the US. Unemployment is currently 3.7% and survey data suggest that it is becoming harder to fill vacancies. A tight labour market has seen an increase in wage inflation and a moderate rise in headline consumer prices. While inflation has also tended to accompany recessions in the past, with prices outpacing wage increases, choking disposable incomes and prompting ever-rising policy rates, this dynamic is also not yet visible in the current data. Wage growth has exceeded inflation, and with lower oil prices may continue to do so for some time. This could, in fact, improve in 2019 relative to 2018.

US WAGE GROWTH VERSUS HEADLINE CPI, INCLUDING FED FUNDS



Source: Datastream

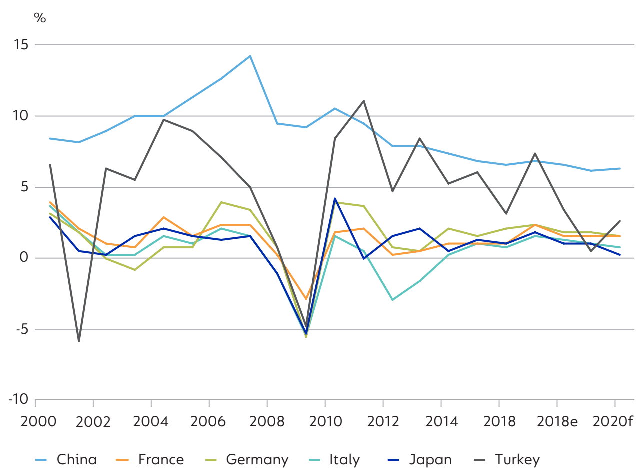
Lastly, the corporate sector is often a factor in the path to and severity of recessionary periods. Rising wage costs, rising debt costs and past-peak profitability are likely to put increasing pressure on margins. Certainly, both wage and interest expenses are likely to rise in coming quarters, but for now, corporate balance sheets remain in reasonably good health and are considerably less stressed than at the tipping point of previous recessions.

Considered together, we do not think that US growth is at risk of a sudden slowdown in 2019. What we do expect for now is that domestic demand will continue in line with the current trend, with some areas of softness, namely housing, being largely offset by stronger consumer spending. It also suggests that the Fed is more likely than not to continue hiking, as data stay consistent with an economy operating at or above potential, and almost certainly by more than current market pricing anticipates. In turn, this implies a relatively resilient US dollar, although we do not anticipate significant additional appreciation from current levels, given a somewhat overvalued starting position.

GLOBAL GROWTH OUTLOOK – DOWN, BUT NOT OUT

Under this US baseline, the outlook for other major markets is also reasonably benign. Europe, which was considerably weaker in 2018 than initial expectations, suffered a series of idiosyncratic hits to growth. While poor weather is a regular disruptor of first-quarter activity, a debilitating flu, strikes in France and changing automobile emissions regulations all affected growth in the two largest economies, with repercussions for the periphery. Italy's political challenges and weak underlying fundamentals saw growth stagnate in the third quarter. A full recovery of lost momentum is unlikely and there is still clear political risk across Italy, Germany and France. Tight labour markets, a recovery in investment and some fiscal support should offset most of the drag from weaker trade.

GROWTH COMPARISON (REAL GDP)



Source: IMF

Similarly, growth in Japan was disrupted by weaker global trade, slowing growth in China and a series of natural disasters. The latter interrupted supply chains and saw a meaningful slowdown in GDP growth during the second half of 2018. Some recovery and rebuilding activity should offset some of the headwinds created by the increase in VAT planned for October 2019, while more stable growth in China will likely provide support for net exports. Japan should also benefit from some 'payback' as disrupted export shipments normalise, even if the global environment is softer than in 2018.

Trade tensions and a long period of credit tightening has seen Chinese economic growth slow from 6.8% year on year (y/y) in the first quarter of 2018 to 6.5% y/y in the third quarter. The recent reprieve in the pace of escalation in tariff increases planned by the US after the G20 summit in December probably will not last, and we expect some increases in tariffs in early 2019. The implementation of policy support by the Chinese authorities has thus far been reasonably constrained and it remains to be seen if materially weaker growth triggers a more dramatic policy response. For now, it looks as though growth of about 6% is achievable under current policy settings. That said, a broader base and higher tariffs are the biggest threat to Chinese growth and would materially increase the risk of a more extreme policy response.

EMERGING MARKETS AT ROCK BOTTOM?

A number of emerging markets suffered market-related disruptions in mid-2018, which had material impacts on their real economies. Turkey saw its currency depreciate almost 40% between January and August as concerns over total foreign-denominated financing needs gave investors pause. The high oil price, excessive credit growth and a wide current account deficit, coupled with relatively high external corporate borrowing, all contributed to the slide. Recent data suggest that the real economic fallout has been severe, with inflation surging to 24.7% y/y, interest rates at 24% and economic growth dwindling to 1.6% y/y.

Elsewhere, Argentina turned to the IMF as liquidity dried up with the withdrawal of investment support. Inflation remains high and any economic adjustment is likely to be painful and slow. Nonetheless, both these economies are expected to stabilise, albeit at weak levels, in 2019. A modest recovery in South African GDP growth and a reasonably steady Russia should contribute to a resilient emerging complex.

NOT WITHOUT (CONSIDERABLE) RISK

There are always risks: probably the most obvious in this context is the heavy reliance on the US as the current driver of global growth. While we think that some stability in Europe, Japan and some emerging markets will buffer a slowing US through 2019, there is significant risk – either that the US slows faster than data currently suggest, or that the economy starts to overheat and the Fed hikes more aggressively into a restrictive policy stance. Over the longer term, the US faces fiscal challenges that could disrupt growth and confidence. An escalation in trade aggression would see China's growth path under considerably more pressure and the Brexit outcome is a clear unknown but looking increasingly chaotic. In Europe, peripheral economies still carry high government debt levels that could become strained should Italy's fiscal position weaken.

Another challenge – especially in the case of a crisis – will be the much tenser and more polarised political positions of major economies. Brexit will isolate the UK from its European peers and affiliated policymakers, while the US is becoming increasingly insular. The consolidation of political power in Russia and China may also be increasingly disruptive and certainly, taken together, may make the coordination of a global policy response much less likely than that seen through the last financial crisis.

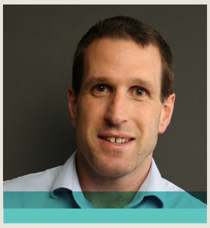
For now, we broadly expect a continuation of 2018 – relatively strong, if increasingly uneven and generally more moderate global growth – throughout 2019. In line, monetary policy should continue a slow path to normalisation in developed economies, while emerging market policy settings are likely to be more mixed. This is a reasonably supportive cyclical context for oversold asset classes, including emerging markets. ✚

Quilter

Reaping the rewards of pension reform

By Nicholas Stein

Nicholas is an equity analyst with 10 years' investment experience. He currently co-manages Coronation's Aggressive Equity strategy and is the manager of the Coronation Resources unit trust fund.



OLD MUTUAL INVESTORS will have had indirect exposure to Quilter for many years. Old Mutual's managed separation process resulted in a core African life insurer, with its UK wealth business (Quilter) and the majority of its Nedbank stake being distributed to shareholders. As a result, investors are now able to own Quilter directly.

In the years leading up to the listing, Quilter management reshaped the business from a pan-European life insurer to a UK-focused wealth management business, with a sizeable presence across the wealth management value chain (advice, platform, multi-manager and discretionary wealth management). It retains a closed book of life business that is in run-off, the contribution of which will decrease in significance over time.

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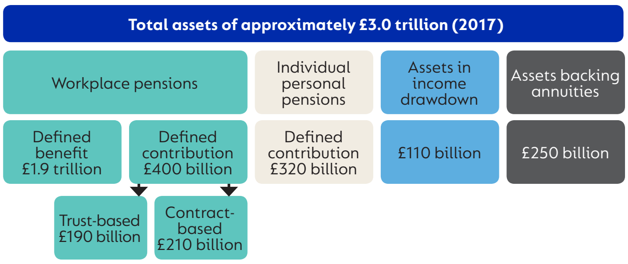
OVERVIEW OF THE UK'S PENSION LANDSCAPE



Source: The Investment Association

The UK pensions market is attractive and has undergone a seismic shift in recent years, following four notable milestones:

- The UK adopted the Retail Distribution Review (RDR) in 2012, which improved disclosure to clients, specifically on fees, and set very onerous requirements that advisors had to meet before being able to describe themselves as independent. It also shifted the industry in several ways – from a commission-based payment structure to one in which the client pays the advisor directly, and with increased advisor qualification requirements, thereby increasing the burden of being an independent advisor. This led to a drop in the number of advisors, from 27 000 in 2009 to 24 000 in 2016, and a switch from independent to restricted advice, and drove industry consolidation. These changes benefitted larger advice firms, of which Quilter is one.

- In 2012, the UK government also introduced pension auto-enrolment, compelling employers to enroll employees in a pension fund. While the initial impact has been minor, this will, over time, improve long-term savings rates and wealth accumulation. It essentially creates a wave of potential future clients for Quilter and its peers.

- In 2015, the UK Chancellor of the Exchequer, George Osborne, announced 'pension freedom', which removed the requirement to buy an annuity at retirement. Consumers could now withdraw their pensions in cash and/or make use of flexible drawdown products. Data from the Financial Conduct Authority (FCA) show that the annuity/drawdown sales mix in 2014 was 81% and 19%, respectively, which evolved to 24% and 76%, respectively, by 2017. As Quilter did not offer fixed annuities, this change represented a massive tailwind to the group and its peers.

- Meanwhile, the UK is shifting away from a defined benefit-dominated market to a defined contribution market. As it stands, 83% of UK workplace pensions are defined benefit funds, accounting for £1.9 trillion of UK retirement savings. Around 88% of these funds are closed to new members, with employers opting to offer defined contribution funds instead. In addition, many companies are opting to remove the funding uncertainty that comes with a defined benefit fund by encouraging members to transfer their pension pots into defined contribution funds. While Quilter and its peers do not offer defined benefit fund solutions, they do offer defined contribution fund solutions (directly in the case of a self-invested personal pension [SIPP] and indirectly in the case of defined contribution fund pots being consolidated in the future). The companies also offer retirement solutions in the form of drawdown products for fund members when they do retire.

If we consider Quilter's core addressable market to be defined contribution funds, SIPPs and drawdown products (they do also participate in discretionary savings), it amounts to £830 billion. According to our assessment, this is likely to expand threefold in the next decade. Quilter's own net flows target over the medium term is 5%, which we believe could prove conservative. So far, it has averaged 7% per annum over the last three years.

QUILTER IS WELL PLACED

Quilter is well placed to take advantage of the supply/demand mismatch created as a result of the introduction of pension freedoms (which are increasing the demand for financial advice) and the RDR (which is reducing the supply of this advice). Alongside industry peer St James's Place, Quilter is the only player to offer every key component of an integrated wealth manager at scale. It also has the second-largest advisor force, the second-largest advice platform and a credible and well-performing multi-manager, and includes the fifth-largest discretionary wealth manager in the country.

SELF-HELP OPPORTUNITIES

Due to its acquisitive history, Quilter remains an inefficient business, although we believe these inefficiencies are being addressed. Over the past decade, Quilter has sold out of most of its European life businesses, bought advice businesses and a discretionary wealth manager, and sold its single-strategy asset manager. While this has set the group up strategically, the company has yet to optimally integrate these businesses. This is, however, likely to be addressed soon, given that the key component parts of the value chain are now in place and that the board has prioritised costs, integration and efficiencies.

A further benefit of a more cohesive business is integrated flows, which occurs when a client makes use of more than one part of the value chain, allowing for greater margin retention by Quilter. Integrated flows have grown from one third of flows in 2015 to half of flows in 2017.

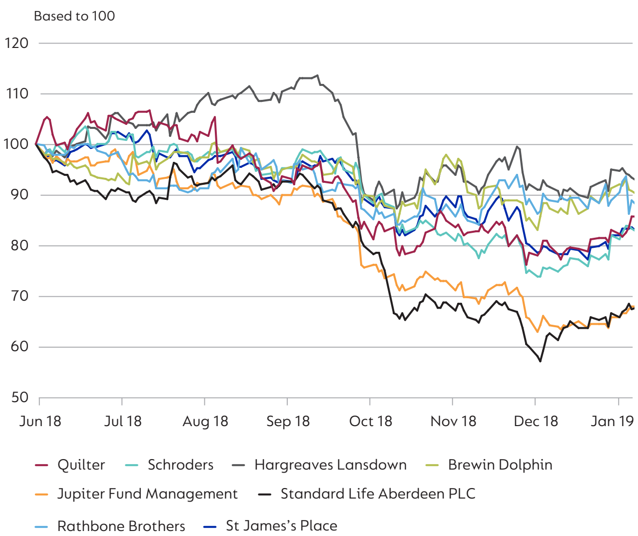
Quilter currently operates off an ageing, proprietary back-end investment platform that has seen no operating leverage, with costs and headcount moving in lock-step with new assets being placed on the platform. Positively, the company is currently in the process of transitioning to a new, third-party investment platform that is expected to show operating leverage, given that the platform provider is responsible for regulatory developments and that the fee reduces as the business scales.

Many investors will recall that this is not Quilter's first attempt to re-platform. Its much-publicised first attempt with International Financial Data Services, which cost £330 million and was subsequently terminated, remains fresh in investors' minds. We believe Quilter has taken the lessons from the first attempt to heart.

We take comfort in the fact that the new provider, FNZ, is used by a number of players in the industry and is held in high regard. Quilter has also strengthened its IT team, and appointed a non-executive director with IT and system migration skills to the board. With a focus on costs and a successful re-platforming, we see scope for margins to improve meaningfully off the current profit-before-tax margin level of 29%.

Quilter is a cash-generative, capital-light business. We find it surprising that they only target a dividend payout ratio of between 40% and 60%, and sit on a Solvency II cover of 1.95 times.

QUILTER SHARE PRICE VERSUS PEERS



Source: Bloomberg

Our view is that, after the successful re-platforming, management and the board have scope to improve the payout ratio while reducing the amount of capital retained to run the business. This should go some way towards driving the share's rating higher.

EARNINGS GROWTH

We expect earnings growth to be muted in the short term as Quilter's tax rate normalises and their closed life insurance book runs off. This masks a strongly growing core UK wealth business, which should grow earnings at double-digit rates over the medium to long term, on the back of strong net client cash flows and positive operating leverage. This is an attractive growth rate in hard currency.

WHAT GAVE RISE TO THIS OPPORTUNITY?

Apart from the risks associated with re-platforming, Brexit concerns also appear to have placed pressure on Quilter and its peers. Our view on Brexit's impact on Quilter in the longer term is fairly benign. Brexit might impact flows if money sits on the sidelines while uncertainty abounds. However, we think the longer-term structural tailwinds will ultimately reassert themselves. To the extent that the pound weakens, this will likely benefit Quilter, given that its fund range is largely global equities. Operationally, the vast majority of operations and clients are UK based, so the impact here should be muted.

CONCLUSION

Quilter operates in a market with structural tailwinds and is well positioned to take further market share, driving good earnings growth. Its business model possesses attractive fundamentals, being cash generative and capital light. The share price offers more than 50% upside to our assessment of fair value, trades on 10.5 times our assessment of normalised earnings, and offers a 5% dividend yield and is, in our view, an attractive proposition. ✚

We need to hurry up and deliver

"The trouble is, you think you have time." – Gautama Buddha

By Marie Antelme

LAST YEAR WAS one in which South Africa celebrated a change in political leadership and, at least initially, had high hopes of a social and economic recovery. These were short lived, and a combination of consecutive growth-related disappointments, revelations of deeper and more intractable political (and private) malfeasance and the slow pace of change saw us end 2018 a little more bruised, possibly more realistic and certainly more downcast than we were at the outset.

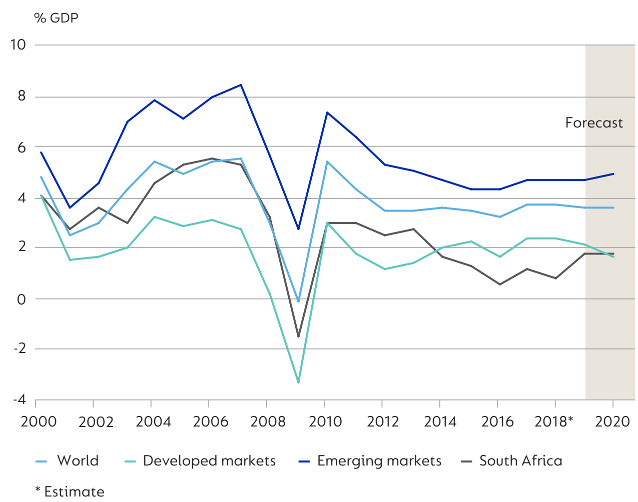
Many forecasters, including ourselves, started 2018 believing that GDP growth approaching 2% was relatively easy to achieve. Within a supportive global environment, a great improvement in consumer confidence – reinforced by low inflation and low but positive real disposable income growth – provided a decent support for consumer spending acceleration despite the increased tax burden. A small amount of replacement capex and at the margin some rebuilding of commercial and industrial inventories from historically low levels all added up nicely.

Marie is an economist with 18 years' experience in financial markets. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

However, little came to pass. With a steady deceleration in compensation (wage) growth, a significant increase in the fiscal burden on consumers (tax bracket changes, a rising fuel levy, the VAT increase and rising utility levies) and not enough confidence to increase credit utilisation, consumer spending has remained weak. State capex retreat pulled overall gross fixed capital formation down.

On the supply side, the deep contraction in agriculture was exacerbated by a series of derailments, refinery outages and strikes that affected mining, manufacturing and transport output. South Africa slid into recession in the first half of 2018 and while there was a nascent recovery in the third quarter (Q3) of the year, it is now unlikely to deliver even half the growth that was forecast at the beginning of 2018.

SOUTH AFRICA VERSUS GLOBAL GROWTH



Sources: IMF, Statistics South Africa, Coronation

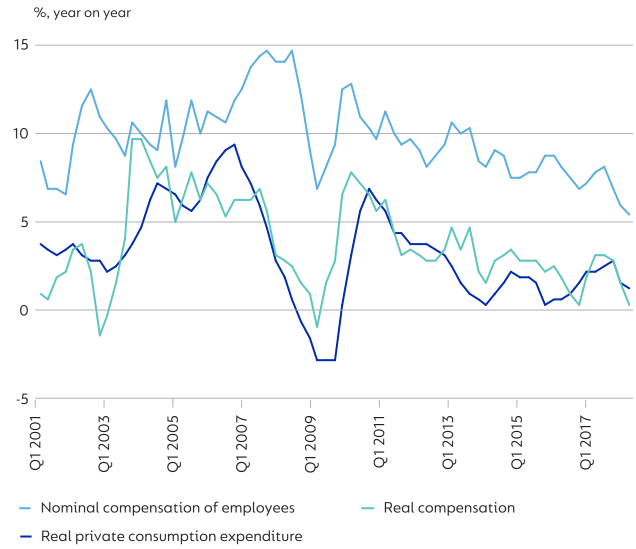
CHANGING MOOD

Through the course of these events, there has been a general deterioration in sentiment. Despite the meaningful and important political changes made in key economic institutions and ministries, the fact is that incomes remain under pressure and the political situation, although vastly improved from a year ago, has not yielded much visible economic benefit. The reality is also that ordinary South Africans simply have not felt that things are getting any better.

At the end of a hard year during which bad news seems to have come in waves, each more depressing than the next, the recent news about the full extent of Eskom's financial and operational failure feels like the proverbial last straw.

So it is hard to see how growth will pick up materially in 2019, and recent data continue to pose downside rather than upside risk to existing forecasts. There are certainly lots of reasons to think that growth momentum will remain under pressure. Household spending accounts for 60% of GDP and compensation growth slowed to 5.4% year on year (y/y) in Q3 2018. This is the lowest nominal growth since the 2008/2009 Global Financial Crisis (GFC). In real terms it is only just positive, and little better than the low point of -0.8% y/y in the second quarter of 2009. Additionally, gross fixed capital formation was 1.4% y/y in Q3 2018 – positive at least, but still historically weak. Private sector job creation is stagnant, while both consumer and business confidence retreated in Q3.

SOUTH AFRICAN NOMINAL AND REAL COMPENSATION VERSUS PERSONAL CONSUMPTION EXPENDITURE



Source: Statistics South Africa

NOT ALL BAD?

But there are areas where pressure has eased and momentum seems to be improving. Stability in compensation growth, which has been slowing steadily, should help improve momentum in disposable income. In December, retail fuel prices were cut heavily, and the rate of increase in monthly outlays should slow steadily. Inflation is set to remain relatively benign and we do not expect the same degree of fiscal pressure to be repeated in 2019/2020. We would again make an argument for some growth in replacement capex and inventory recuperation – now off even lower levels than last year – but uncertainty remains.

At the margin, some small boost from capital committed during President Ramaphosa's Investment Summit will also help. The falling oil price, if sustained, implies an improvement in terms of trade and a more positive contribution to growth from net exports. On the supply side, both mining and manufacturing output improved towards year-end. Our long-held forecast is for growth to accelerate to 1.8% in 2019.

THE ESKOM ELEMENT

Eskom is now the biggest and most immediate domestic threat to growth and a positive political outcome. From a growth perspective, meaningfully higher electricity tariffs will raise inflation and undermine household disposable income growth. Supply disruptions undermine not only business confidence but also inhibit the ability of companies to produce output.

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The fiscal risk posed by Eskom is meaningful. Not only has Eskom asked for significant tariff increases of 15% per annum over the next three years, but the latest results also contained a request for R100 billion in debt to be transferred to the state balance sheet.

This amount represents about 2% of GDP and would – under this proposal – increase South Africa's government debt stock by as much. Government is already in a fiscally constrained position, with the October Medium-Term Budget Policy Statement detailing yet another deterioration in the government's debt profile over the next five years and the expectation that annual fiscal deficits are likely to be larger than previously budgeted for.

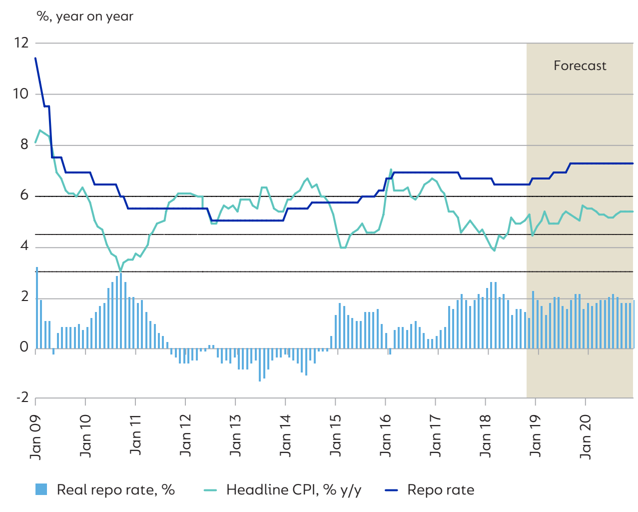
Gross debt is expected to continue to climb to a peak of 59.6% of GDP in 2023/2024 and moderate very slowly thereafter. The request potentially creates a dangerous precedent and the fallout might be enough to change South Africa's last remaining investment grade credit rating.

The good news is that inflation is unlikely to also become a big headwind for the consumer. Relatively low food inflation provides a good anchor for overall inflation, but a sharp decline in retail fuel prices – and base effects – help contain two large and potentially volatile influences of headline inflation. The weak economy has also seen a steady moderation in service prices and limited much of the pass-through from a volatile and weaker currency.

Administered prices, including Eskom, remain a large inflationary influence on headline inflation and arguably still represent a tax on consumption. We forecast average CPI at 4.6% in 2018, with a modest acceleration to 5.3% in 2019.

In this environment, we think there is limited scope for a steady interest rate hiking cycle, and anticipate moderate and slow rate increases by the central bank in 2019. Both our inflation and interest rate forecasts carry downside risk at this point. Incoming data suggest global growth momentum continued to slow into year-end.

INFLATION AND RATES



Sources: Statistics South Africa, Coronation

CAN WE AVOID THE GLOBAL HEADWINDS? MAYBE, MAYBE NOT

That we experienced a very weak progression in domestic growth during a period in which the global economy experienced the most joined-up recovery in a decade – albeit now slowing and becoming much less even – raises understandable concerns that any local recovery in a weaker global context is unlikely. Certainly, slowing global trade volumes and weaker growth in key export partners are a clear headwind.

What is possible is a cyclical recovery driven by domestic demand. This requires the alignment of some recovery in domestic growth drivers outlined above and the rehabilitation of a range of supply-side one-offs, including various outages, strike action and Eskom's load shedding. Because the economy has not grown, there are also few visible excesses – household balance sheets are in reasonably good shape, credit growth has been low and households have deleveraged. Employment has been poor, capex visibly weak and confidence is low. The current account deficit is relatively small. If the economy has not managed to grow, at least there are fewer parts which are exposed to a potentially sudden stop.

WHAT WE NEED IS TIME

While this is hardly an uplifting picture, it is a hopeful one. What now stands in the way is time. Linked to the clear frustration with an economy seemingly stuck in low gear has been a growing expectation that the necessary and painful reform needed to unlock better growth – much of which faces some opposition from the ANC-led alliance partners – will become manifest after the May 2019 election. However, we are more hopeful that the marginal changes to policy already announced will gain velocity and that the quality of the conversation between the public and private sectors will continue to improve than we are of an election delivering a political payload that would significantly impact economic policy.

But what we do not have is a lot of time. Growth has been low for so long that it is at risk of stalling. Low growth limits options: it reduces revenue and undermines the state's ability to more productively allocate capital, it limits employment opportunities and makes earning a wage capable of raising living standards impossible, and it discourages investment.

And those factors are just what we need. The swift delivery on some of the promises made, including the release of spectrum* and an accelerated and urgent review of visa regulations might only go a small way to boosting growth at first, but they could go a long way to bolstering confidence that there is more to these commitments than just words and to addressing some of the practical constraints to key growth areas. We also need an intervention which prevents Eskom from totally derailing these emerging green shoots, and we need it soon. ✚

* Making additional radio frequencies available will boost wireless network capacity. This will bring down the cost of communication and increase internet access, which is essential to economic growth and innovation, ensuring that South Africa keeps pace with the 4th industrial revolution.

The winds of change blow through the Americas

But overcoming deeply rooted economic problems remains challenging

By Suhail Suleman

Suhail is a portfolio manager within the Global Emerging Markets investment unit. He joined Coronation in 2007 and has more than 16 years' investment experience.

IN RECENT YEARS there has been a gradual shift away from leftist parties which have held sway across the Latin American region for the greater part of the last 20 years. In their national elections, countries such as Chile and Argentina elected presidents who are to the right of the political centre, while countries like Colombia and Ecuador have also recently elected presidents closer to the centre than their left-leaning predecessors. There is a variety of reasons for this shift, but the central theme has been that government spending in many countries had ramped up to unsustainable levels and change was needed.

Regrettably, Venezuela, the country most in need of a change in government, remains ruled by the same clique responsible for its decline from the wealthiest country in Latin America (in GDP per capita terms) to a socioeconomic basket case. Venezuela's

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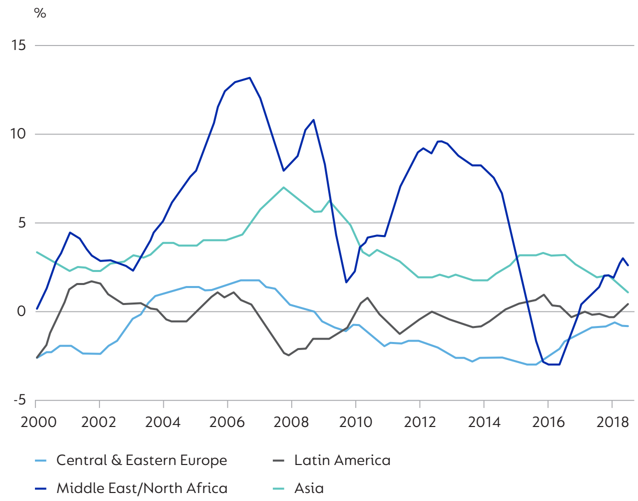
descent is unprecedented for a non-war nation in Latin America and seems to be interminable as more and more refugees depart for neighbouring countries, fleeing the effects of a perfect storm of policy weakness, corruption, housing and food shortages, and hyperinflation. Estimates of an exodus of four million people out of a population of 32 million indicate the scale of the humanitarian crisis at hand.

CURRENT ACCOUNT BALANCE BY REGION

12-month cumulative, % GDP



Source: Emerging Advisors Group, December Monthly Chartbook, derived from national accounts data

STRONG-ARM TACTICS BY REGIONAL HEAVYWEIGHTS

With the above in mind, 2018 served up two very interesting elections in the region's two biggest economies – Mexico and Brazil. First up in Mexico was far-left Andrés Manuel López Obrador, known to most by his initials 'AMLO', having lost the previous two elections to Felipe Calderón (2006) and Enrique Peña Nieto (2012). In the case of his defeat to Calderón in 2006, the margin was so narrow (35.9% for Calderón to 32.3% for AMLO) that he proclaimed himself the 'legitimate' president after alleging electoral fraud in favour of Calderón. Mexico's election tribunal ultimately ruled against these allegations, but the perceived lack of legitimacy took its toll on Calderón's presidency.

In 2018, there was no doubt about the election result – AMLO won an absolute majority of votes and beat his nearest challenger by over 30%. The result was greeted with some fear by the market, given the new president's historic aversion to market-based solutions to economic problems.

Obrador has railed against neoliberalism and has been very critical of the energy sector reforms introduced by his predecessor that ended the monopoly of state-owned oil producer, Pemex. These reforms were necessitated by years of declining infrastructure investment and a drop in output from 3.5 million barrels per day (bpd) in 2004 to under two million bpd in 2017, with a corresponding impact on Mexico's fiscus. Should these reforms be reversed, and if the new government acts on its promise to freeze energy prices, the fiscal situation in Mexico could deteriorate rapidly.

The experience with fuel subsidies in other countries (such as Indonesia) suggests that freezing fuel prices benefits the middle classes far more than the poor and is rarely good policy, as it diverts scarce state resources away from investment. Another worrisome early action was an informal referendum called by AMLO shortly after winning the presidential election and prior to his inauguration. The referendum, which was not carried out by the official electoral authority, asked the public whether the planned new airport for Mexico City should go ahead.

After a large majority of those who took part voted against the new airport, AMLO announced that he would respect the vote outcome despite the negligible turnout of one million voters in a country of 130 million people, and despite the new airport being one third built and billions of dollars in financing having already been raised.

The direction of Mexico under AMLO will be important during his tenure. His six-year term will have at least two years of overlap with Donald Trump's presidency and the US president's historical animosity toward migrants from Mexico (and those from elsewhere who use Mexico as their transit route to the US) looks set to have a substantial impact on their relationship. AMLO has been characterised by Western media as a "fiscally responsible populist" which, if accurate, suggests that Mexico should muddle along for his six-year term. This is better than a Venezuela-style implosion but does not suggest that Mexicans will experience a sustained improvement in their living standards either.

FROM PEAK TO TROUGH

From an investment perspective, the bigger impact on the emerging markets universe will be made by the election in Brazil. The country has been under left-wing PT (Workers' Party) rule since Lula da Silva's election in 2002 through to the removal of his successor, Dilma Rousseff, via impeachment in 2016. (Rousseff, like Lula, also won two consecutive presidential elections.)

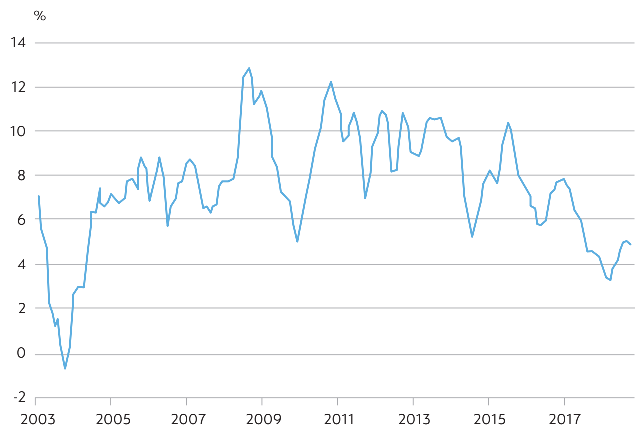
The early years of PT government went well, largely sustained by the commodity boom, as Brazil is a big exporter of iron ore and agricultural products. The country rebounded very quickly from the 2008/2009 Global Financial Crisis (GFC) and looked set to finally break its historical reputation as being the perennial 'country of tomorrow'.

Alas, the foundations of Brazil's growth under the PT government were quite poor – heavily reliant on consumer spending, unsustainable minimum wage increases, fiscal largesse and the commodities boom. There was also substantial corruption in Petrobras, the state-owned oil company that had been used to enrich many politicians and businessmen through rigged contracts and outright bribery.

The boom years also saw Brazil's currency appreciate significantly against its trading basket, which made manufactured exports uncompetitive and imports much cheaper. Brazil therefore maintained historical tariff and non-tariff barriers while the

INFLATIONARY WAGE INCREASES

Growth rate (%, year on year)

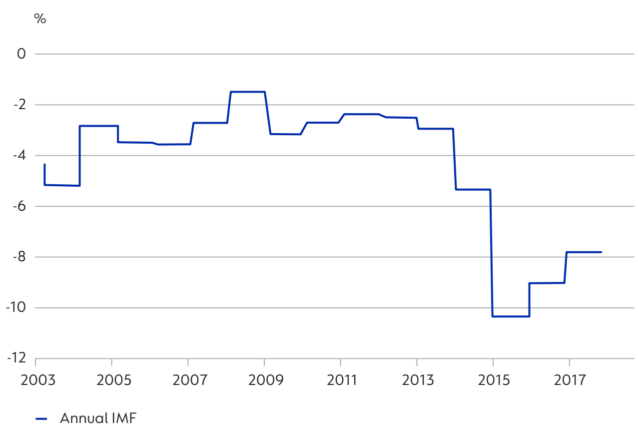


Source: Emerging Advisors Group, December Monthly Chartbook, derived from national accounts data

rest of the world was reducing these, further eroding international competitiveness. The deterioration in the fiscal situation eventually led to a hard landing in 2015 and 2016 when a combination of an economic contraction of 7% and double-digit inflation plunged the country into its most severe recession on record. The currency also depreciated by 85% against the dollar over the one-year period from September 2014 to record lows since the introduction of the Brazilian real in 1994, an event that brought an end to persistent hyperinflation.

Despite having just been re-elected in 2014, public opinion moved rapidly against then-president Rousseff as the economy continued to deteriorate. This led to her eventual impeachment by Brazil's Congress and Senate on charges of breaching Brazil's budget laws. Vice President Michel Temer served the remainder of her four-year term, achieving very little during those two years due to corruption allegations against him. This hindered his ability to attain Congressional support for some of the tough reforms that Brazil needs to enact to deal with its perilous fiscal position and very burdensome regulations that retard economic growth.

FISCAL BALANCE (% GDP)



Source: IMF

The 2018 election therefore resulted in a showdown between left and right. Da Silva intended to run again, as the constitution imposes a two-term limit for consecutive elections, but after sitting out at least one cycle, a former president is free to run again. Unfortunately for him, he was jailed earlier in the year for corruption and, after losing several appeals, was declared ineligible to stand. His party nominated Fernando Haddad, a former mayor of São Paolo, as its candidate. With centrist parties failing to gain traction, Haddad came up against Jair Bolsonaro, a congressman for close to 30 years.

Bolsonaro has been described in the media as Brazil's Donald Trump, due to his tendency to make provocative and unconventional statements. He has spoken fondly about Brazil's time under military rule (he served in the military before entering Congress) and denigrated certain groups of people based on his staunch religious views.

With the Brazilian electorate very angry with the PT party for its failings under Da Silva and Rousseff, it was almost inevitable that whatever the shortcomings of the alternatives, the leading non-PT candidate would win.

That eventually came to pass, as Bolsonaro won comfortably in the second round of the election by around 10 percentage points. The scale of the task awaiting his administration is daunting – Brazil runs a budget deficit that has exceeded 5% of GDP for each of the last four years. Government debt to GDP is now in excess of 70% and continues to rise. With close to double-digit interest rates and a poor credit rating, Brazil must spend 6% of GDP just servicing the interest on its debt.

Brazil's generous pension and social security system allows many public employees to retire in their fifties (with a life expectancy of 75 years) and spending on these benefits consumes over half the federal budget. Without drastic entitlement reform, it will be impossible to get Brazil into a sustainable fiscal situation. Bolsonaro lacks a majority in Congress to force through reforms without cross-party backing, so there is potential for continued deadlock and for the fiscal situation to spiral further out of control.

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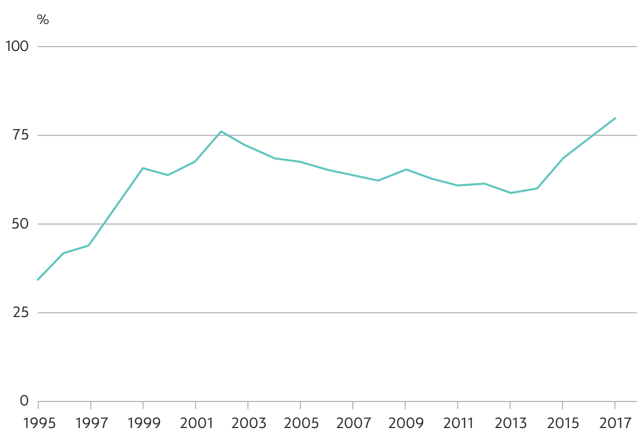
BRAZILIAN DEBT TO GDP



Source: IMF DataMapper

Because of these challenges, the administration put in place by Bolsonaro is very important. Early indications are that good technocrats will be in charge of key administrations and that the incoming government is committed to cutting red tape and making Brazil an easier country to do business with.

There are many attractive domestic industries in Brazil that we believe have good investment opportunities. The fragmented nature of the higher education sector, the clothing and food retail sectors and the healthcare industry overall provides an opportunity for market leaders and entrepreneurial management teams to deliver high returns for shareholders over the medium to long term. Our Global Emerging Markets strategy continues to identify and research these potential investment ideas to complement the 12% of the strategy that is currently invested in Brazil. After several tough years, valuations in Brazil remain very attractive in a variety of businesses, even relative to the overall global emerging markets universe after its decline last year. ✚

This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein may currently be held in Coronation managed strategies, however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a company's underlying fundamentals or valuation measures change, Coronation will re-evaluate its position and may sell part or all of its position. There is no guarantee that, should market conditions repeat, the abovementioned companies will perform in the same way in the future. There is no guarantee that the opinions expressed herein will be valid beyond the date of this presentation. There can be no assurance that a strategy will continue to hold the same position in companies described herein.

2018 fourth quarter in review

CORONATION GLOBAL HOUSEVIEW STRATEGY

It was a disappointing year, with markets experiencing broad-based asset declines. During the fourth quarter of 2018 (Q418), global markets sold off sharply. The MSCI All Country World Index declined by 12.8%, while the US market was down 14% as trade wars and slowing global growth plagued market sentiment. In the UK, Prime Minister Theresa May survived a vote of no confidence, but the chances of a no-deal Brexit rose and the FTSE 100 Index declined 11.7%. Emerging markets (-14.6%) underperformed the developed world (-8.7%) over the year but did relatively better in Q418. Emerging market risk aversion saw portfolio outflows and notable currency depreciation for the year in South Africa (-14%), Russia (-17%) and Turkey (-28%), relative to a strong US dollar. It has been many years since we have been able to buy high-quality businesses at the undemanding ratings currently available in many emerging markets.

The Bloomberg Barclays Global Aggregate Bond Index was up 1.2% for the quarter, but down 1.2% for the year in US dollars. We remain cautious on global bonds, given the very low yields at which they trade, coupled with an environment of normalising interest rates and the risk of rising inflation. In South Africa, the All Bond Index returned 2.7% for the quarter, bringing annual performance to 7.7%, which compares favourably to other domestic asset classes.

Over the year, investor sentiment in South Africa deteriorated as Ramaphoria evaporated and structural concerns reasserted themselves, as the dire state of many state-owned enterprises (SOEs) was further revealed. Most sit with inflated wage bills from overstaffing and years of above-inflation pay increases. The job cuts required to rein in costs are a tough call for a divided governing party facing an election in the next few months. Following the election, we are hopeful that a stronger mandate for the incumbent will enable more decisive reform. Eskom remains a significant problem, with its strained balance sheet and years of poor maintenance resulting in the reoccurrence of load shedding in an economy already struggling to grow. A proposal to transfer R100 billion of the parastatal's debt to the government's balance sheet would erode national debt-to-GDP by a further 2%.

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Positively, there has been progress on governance, with SOE boards being reconstituted and underperforming management teams being replaced. In addition, third-quarter GDP figures indicated a return to growth, although a further hurdle came in the form of the South African Reserve Bank's surprise repo rate increase of 25 basis points in November. This action was premised on a depreciating rand, persistent electricity price increases and a high oil price. Food inflation also looks set to rise in 2019, with maize prices spiking in response to a poor rainy season in key planting areas.

The FTSE/JSE Capped SWIX All Share Index ended 2018 down 10.9% (down 3.8% in Q418) as the euphoria of the first quarter subsided, resulting in both weak equity markets and a marked deterioration in the currency. The rand was one of the weakest currencies globally. Worldwide, markets were also weak as fears of trade wars, rising US inflation and the reversal of years of quantitative easing plagued market sentiment. Full-year index returns were dominated by the resource sector (up 16%), which was driven by globally diversified miners such as Anglo American (+32%) and BHP Billiton (+28%). Given weak global markets, domestic sentiment erosion and several stock-specific issues in offshore shares listed domestically, both financials (-9%) and industrials (-18%) declined over the full year. All sectors declined in Q418, with financials, resources and industrials down 2%, 5% and 6%, respectively.

We have the fortunate dilemma of seeing attractive value in both the offshore shares and domestic shares listed on the JSE, given the increased upside to our estimates of fair values after a year of marked declines.

The portfolio's core building blocks remain in place, with significant positions in offshore stocks, including Naspers, British American Tobacco and MTN. All of these companies have faced various challenges over the past year. In addition, we have used price weakness to build positions in other global businesses, including Quilter and Anheuser-Busch InBev.

Earlier during the year, MTN was hit by claims from the Central Bank of Nigeria and the Nigerian Attorney General for capital repatriation of $8 billion and $2 billion in back taxes. The share reacted violently to the news, with sharp declines, and priced in a severe outcome, with seemingly no value placed on the Nigerian operations. The actions of the Nigerian bodies attracted international attention as the investment climate was broadly undermined. We added to the position at this time. The issue of repatriation has subsequently been resolved for a notional amount of $52 million. Despite resolution, shaken investor confidence means MTN continues to trade well below our opinion of fair value, as we see investors placing an excessive discount on African operations.

British American Tobacco, a major holding in the portfolio, ended the quarter at -27.4% and the year at -43.4%. The company significantly increased its exposure to the US market with its 2017 acquisition of Reynolds American, but since then, US tobacco companies have been plagued by a barrage of negative regulatory developments. The US Food and Drug Administration seeks to clamp down on tobacco levels in conventional cigarettes and reduce flavoured tobacco, particularly menthol, where British American Tobacco is the market leader. In addition, the market is facing structural change as reduced-harm offerings, such as vaping, could result in an accelerated volume decline in combustible cigarettes.

New entrants (particularly Juul in the US market) have managed to establish good distribution channels and gain market share through a well-designed product with youth appeal. The share has been punished in response to these factors and the high levels of gearing from the Reynolds acquisition. Trading on 7.6 times its forward earnings and with a dividend yield of 9%, we believe the share offers exceptional value. British American Tobacco's healthy free cash flow conversion and the likelihood that any regulatory change will take a few years to implement will support balance sheet de-gearing. Given the ongoing negative news flow (regulatory developments, the rise of e-cigarettes and the like), there seems to be little price support, despite the valuation underpin. Ultimately, we believe fundamentals will assert themselves.

Naspers remains a large holding in the portfolio, given the compelling opportunity set latent in this business. We remain cognisant of the inherent risk in Tencent, particularly given its size and dominance within a single, centrally controlled market such as China. During the past year, delays in Chinese gaming licences have proved a headwind. Despite this, we expect strong growth to continue. Tencent is building a payments business in a financial services market segment many times larger than the gaming market, and is growing rapidly in areas such as cloud services and advertising. Within Naspers, streamlining of the portfolio continues, with more focused investment in core pillars, such as the rapidly growing food delivery businesses. A planned unbundling of the MultiChoice business in 2019, as well as a potential offshore listing of some of the internet assets, further underpin management's commitment to reduce the discount to fair value.

While our equity and balanced portfolios remain significantly exposed to offshore stocks, we have increased the domestic holdings, resulting in a more balanced portfolio.

Domestically, we believe earnings bases are low, as cost bases have been trimmed and companies have faced several years of a tough economy, with little volume. The food retailers owned in the portfolio are a good example. Rising food inflation and a (hopefully) stronger economy should provide food retailers and producers with the ability to raise prices and recover cost increases. A little bit of volume should deliver positive operating leverage, given the lean cost bases.

The resource sector performed well over the full year; Q418 declines can be attributed to the rising uncertainty over Chinese economic growth. Resource companies have benefitted from tight markets due to disciplined capital expenditure and Chinese environmental reform. China's commitment to environmental reform remains, but slowing growth means a finer balance may be needed between economic growth and environmental reform. While uncertainty exists, we believe a reasonable position can be justified. Miners are trading on high free cash flow yields and returning a fair amount of this to shareholders. The portfolio's core holding in Anglo American contributed to performance for the year, buoyed by Amplats. Other key portfolio holdings include Northam Platinum and Mondi. Northam has underperformed the other platinum miners, but its cost quartile position should improve as it ramps up production in the next few years.

Within the financial sector, performances were divergent. Banks and insurers outperformed the property sector, which was hit by a weak economy, undermining the position of landlords. The financial holdings in the portfolio are more skewed towards the banks, with a large holding in Nedbank, which trades at a significant discount (PE 9.2 times) to the banking sector average. We also see value in a few of the high-quality property companies, notwithstanding the risk of an Edcon bankruptcy later this year.

Shares with exposure to the UK remained under pressure due to high Brexit uncertainty, as was reflected in the very poor share price performances of Intu and Hammerson. Both shares trade at massive discounts (>50%) to their underlying net asset value. The premium nature of the shopping centre assets in both counters should be far better placed to navigate the shifting retail environment. We feel this thesis was affirmed in 2018 when Intu received its second expression of interest at a significant premium to the share price. Unfortunately, after requesting an initial extension, the consortium walked away during Q418 due to macroeconomic concerns related to Brexit, which remain an overhang.

Earlier this year, we added to the position in domestic bonds as yields rose and valuations became more reasonable. Domestic bonds have generated a positive return for the year, but we believe the position remains justified, given reasonable valuation.

Outlook

It has been a challenging year. Shares prices plummeted on disappointing news flow, and there have been few marginal buyers for assets with uncertainty. Given the extent of share price declines, we see compelling value in many names which now trade at significant discounts to our assessment of fair value. The team continues to do as we have done before; cut out the noise, work hard to interrogate investment theses and invest for the long term, where we believe the inherent value in many of our holdings will reassert itself.

FRONTIER MARKETS

Global Frontiers

Calendar year 2018 was a tough year for equity investors globally. Frontier markets were no exception, with the MSCI Frontier Markets Index down 16.4% over the period. This followed a positive 31.9% return in 2017. The pain was broad based, with all major markets, bar Kuwait (+0.6%), in negative territory. The strategy was down 8.5% in 2018. While a year where capital is lost is never easy, outperforming the index by 7.9% is significant and something we are certainly proud of. Over the past 25 years of investing at Coronation, our value investment philosophy has most often outperformed in bear markets. Buying shares with a significant margin of safety provides some protection when market sentiment turns. This approach paid off in 2018, with the strategy outperforming both the MSCI Frontier Markets Index and the MSCI Emerging Markets Index, which fell 14.6% in 2018.

Over the year, the worst performing frontier market was Argentina (-50.2%). The government was forced to approach the IMF for a $60 billion package as inflation spiked and capital fled the country. This saw the peso halve in value against the dollar. At the start of the year, due to concerns around valuations, the strategy had limited Argentine exposure (2.9%) through a single holding, and sold out completely in the first quarter of 2018 as its share price moved past our fair value. This helped limit the impact of the crisis on the strategy, despite Argentina being one of the largest constituents in the MSCI Frontier Markets Index. More recently, the currency has stabilised. Interest rates have been hiked and the IMF deal-related policies have gone some way to restoring investor confidence.

With valuations having become significantly more attractive, particularly in US dollar terms, we have selectively added some high-quality Argentine corporates to the strategy. Bottom-up fundamentals look appealing, and the margin of safety has increased to an attractive level. Argentina made up 7.7% of the strategy at year-end. The strategy's largest exposures are Egypt (15.4%) and Bangladesh (12.9%). As always, country weights are a function of the attractiveness of individual companies in each market rather than a macro or index view. In fact, for much of the year, the strategy held no exposure in Argentina and Vietnam – two of the largest weightings in the MSCI Frontier Markets Index – due to valuation concerns.

A number of the other major markets were down significantly in 2018, including Pakistan (-25.1%), Sri Lanka (-20.3%), Nigeria (-18.6%), Kenya (-16.9%), Bangladesh (-15.2%), Egypt (-13.8%), Vietnam (-11.2%) and Romania (-9.0%). Each country was impacted by its own internal dynamics; however, the result was largely the same – negative. Kuwait (+0.6%) was the only positive performer as its 'safe haven' reputation and noise around an upgrade to emerging market status kept the market in positive territory, albeit barely.

On a stock-specific basis, Ceylon Tobacco (a Sri Lankan tobacco manufacturer) and Stanbic Holdings (a Kenyan bank) were the largest contributors, with Al Eqbal Tobacco (a global shisha producer) and Hum Network (a Pakistani TV broadcaster and producer) the largest detractors.

While years like 2018 are always difficult to stomach, they do have the effect of resetting valuations across many of the companies that we look at. For the first time in a while, we are seeing upside in a number of high-quality companies with long-term compounder economics. These are businesses that we would have loved to buy in the past, were it not for excessively optimistic valuations. Many of these shares have now re-rated to levels that we believe are attractive, and we have added some to the portfolio recently.

In its *Frontier Markets in 2019* research note, Citibank calculate the forward price to earnings in Frontier Markets as 10.7 times. This is the most attractive level in three years. They go on to exclude Vietnam and Kuwait, two of the more expensive markets, resulting in a forward PE of 8.7 times. This is the lowest level in five years for

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these markets. While market PEs are always going to be a blunt instrument, they do corroborate what we are seeing on a stock-specific basis in our own fair value ranking table. We are unsurprisingly bullish on the portfolio's prospects over the long term.

Africa Frontiers

After a strong start to the year, 2018 turned out to be largely negative, with Nigeria (-18.6%), Kenya (-16.9%), Egypt (-13.8%) and Morocco (-10.2%) all experiencing meaningful declines.

The fourth quarter of 2018 showed a similar picture, with Egypt (-11.3%), Kenya (-7.3%), Nigeria (-3.8%) and Morocco (-0.9%) all declining. However, we have seen that the volatility in African markets present opportunities to acquire stakes in high-quality companies operating in high-growth markets.

In the quarter under review, British American Tobacco Kenya was up 23.7%, while Eastern Tobacco was down 11.6%. It was the most significant detractor over the quarter, but remains one of the largest contributors to the strategy's performance over longer periods. Eastern Tobacco is the largest position in the strategy. It is a business with excellent fundamentals where we believe there is significant potential to continue to grow earnings for many years to come.

At the start of the year, we saw a lot of optimism in Zimbabwe ahead of the elections. Unfortunately, the liquidity situation deteriorated during the year. Up to now it has proved difficult to attract foreign investment, and the government's expectation that it would see large funding from various countries and institutions after the elections is yet to materialise. We saw a deterioration in the liquidity situation in the country, particularly over the past three months. One data point which shows this is the Old Mutual dual pricing discount, which fluctuated around 40% at the beginning of 2018, but widened to almost 90% in October 2018. This has since improved somewhat to a discount of around 80%.

Despite the tough environment, the Zimbabwean companies we own in the strategy continued to perform well. For example, the mobile money business of Econet Wireless Zimbabwe (Econet) has close to 100% market share in a country where virtually all payments now happen electronically. As a result, Econet has seen a dramatic increase in profitability. Given that there has not been an improvement in the liquidity situation in Zimbabwe, we continue to value the in-country Zimbabwean assets at our assessment of fair value, which is significantly lower than the quoted share prices.

The consideration of environmental, social and governance (ESG) issues in the investment process is something that is very topical and front of mind for many investors, but it is one of those things that is often hard to quantify. At Coronation we are big supporters of ESG, and as part of our investment process we spend a lot of time on ESG analysis. We do not only do this for the impact that good ESG practices have on society; we also believe it offers real financial returns to investors.

In frontier markets we have seen a number of examples of companies where corporate governance is not particularly good, but in our experience, this is mostly due to ignorance rather than intent. These are often early-stage businesses, companies that might still be controlled by the founding family, or which have not yet introduced all the procedures that one finds in large, established multinational businesses.

We believe there is a huge opportunity for investors in these markets. Investors are willing to pay much higher multiples for companies that are good allocators of capital, with strong corporate governance. When the governance at a company goes from poor to good, the re-rating one sees in the share price is usually quite significant.

In our view, the most important responsibility of a management team is to allocate capital appropriately to the benefit of all shareholders. When meeting with management teams, we often spend large portions of these meetings engaging on, debating and frequently challenging their strategic decisions and views on capital allocation.

There are also various examples where we have voted against resolutions at the annual general meetings of companies we are invested in. We make a point of communicating our reasons to the company if we are not in support of a particular resolution, and we have seen that this has resulted in management teams taking our suggestions on board and committing to implement certain changes.

A recent example which demonstrates how seriously we take corporate governance, is our engagement with the management and other minority shareholders of Econet over the past few months. While we believe that Econet's underlying business is very good, we are extremely unhappy about certain proposed transactions, which in our view were going to benefit the founder at the expense of minority shareholders.

In 2017 Econet had a deeply discounted rights issue where the company forced shareholders who wanted to take up their rights to subscribe for debentures. By issuing debentures it was not necessary to increase the company's share capital – which would have required a 75% vote – and the resolution was passed with a simple majority. The highly unattractive nature of the debentures, however, excluded a number of minority shareholders from participating, given that their underlying investment mandates did not allow holding this type of debt instrument. As a result, Econet Wireless Global (EWG) – the largest shareholder and a company owned by the founder – ended up owning the bulk of these debentures.

In November 2018, Econet announced that it intended to convert all debentures to shares at the same discounted rights issue price. This would effectively amend the 2017 rights issue and place debenture holders in the position they would have been in had they subscribed for shares. This is a material change in the terms of a pure debt instrument that was never meant to be converted into equity. The conversion is extremely attractive for debenture holders and will be very dilutive for equity holders, as it will increase the shares in issue by more than 40%. With EWG owning a disproportionate number of the debentures, the conversion will increase its stake in the company from approximately 43% to around 47%.

When the proposed conversion was announced, we wrote a letter to the board, made a call to one of the directors and communicated our concerns to the Zimbabwe Stock Exchange. We also had calls with a number of other minority shareholders who shared our concerns. The result was that the company did not gain sufficient support for the debenture conversion; we strongly believe that it was in the best interest of minority shareholders that the conversion did not take place.

Another example during the quarter was the letter we wrote, together with other minority shareholders, to the board of Global Telecom Holding, to share our views on the offer they received for their businesses in Pakistan and Bangladesh. In our view this offer from the largest shareholder significantly undervalued these businesses and the end-result was that the transaction did not go through.

Going forward, topics such as governance and capital allocation will remain key in our engagements with the companies whose shares we own on behalf of our clients. We are very excited about the year ahead. The valuations of many high-quality businesses have reduced meaningfully over the past year, and they now offer exceptional value. By owning these businesses that trade well below our assessment of intrinsic value, we believe investors will be rewarded over the long term.

To conclude

Thank you for your support. It is particularly valued in years such as 2018. We do not take your faith in us for granted and continue to work hard to select companies across global frontier markets that trade well below our estimate of their intrinsic value. Over time, we expect that the market will come to realise this and that our investors will be rewarded.

GLOBAL EMERGING MARKETS

Please refer to the article on page 10 for a detailed review of our global emerging markets views. ✚

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