Turning points
To herald the turning of the decade, we take a look at the world from a broad perspective as the impact of geopolitics is being felt in both global economic policy and the markets. That said, while cognisant of these events and their impact on sectors and regions, we remain committed to our bottom-up, valuation-driven investment approach.
HAPPY 2020 AND welcome to the first edition of Corospondent of the new decade. I know it’s a cliché, but it really is scary how quickly time has gone by and, by that measure, how many of us in this industry have matured. For me, entering this new decade offered a moment’s pause to reflect on the last 10 years and the experiences that have shaped us and left us, hopefully, wiser.

**REFLECTING ON THE HIGHS AND LOWS**

The start of 2010 was still very much characterised by the aftermath of the Global Financial Crisis. This hangover continued to mar investor confidence for the whole of the last decade, leaving trust levels in the financial services sector at an all-time low.

There was no Spotify, Uber or Netflix (I really can’t remember how I binge-watched those series – DVD box sets, I think!). And of course, neither chasing likes on Instagram nor venting through the 140-character limit on Twitter. The tech revolution materially shaped the last 10 years. While it has mostly acted to improve friction points in our daily lives, it has, of course, given rise to other issues.

Sporting highs shaped the beginning and end of this last decade. 2010 was all about ‘Ke Nako’ (‘it’s time’), and hope and euphoria filled our streets as we hosted a very successful Football World Cup. The vibrancy of our national spirit was shared with the world one vuvuzela at a time. And let’s not forget last year’s fantastic win by the Springboks who proudly brought home the Webb Ellis trophy, reminding us that we are indeed #StrongerTogether.

But despite these exhilarating moments, the last decade has also been a truly dark and depressing one for our country.

**A dark decade for South Africa**

And I don’t just mean loadshedding! The 2010s was a troubling decade for local politics, with systemic corruption epitomised by #ZuptaMustGo and #PayBackTheMoney – neatly describing deeply entrenched State Capture and the gross mismanagement of State-owned entities. The hope and potential that were heralded by being included in the rising BRICS grouping has faded, and we currently stare economic ruin firmly in the face. The full costs of rebuilding our economy, and the repercussions of these years of corruption on society and investor confidence will have a material impact on the country for the next decade at the very least.

The global environment has gone through immense change

Globally, we have seen a decade of unprecedented monetary stimulus, resulting in the longest bull market in US history, and taking global stock markets to lofty valuations.

In 2020, we move into an election year in the US, following the December 2019 election in the UK. One cannot help but reflect on the stark contrast between the Obama/Cameron leadership combination and the Trump/Johnson duo currently occupying office. Both incumbents are controversial characters, arguably elected through harnessing the power of social media and targeting disenfranchised voters who feel left behind in this disrupted world.

When the G20 gathered in London in 2009, only a small minority of world leaders would have fitted the right-wing populist mould. Fast forward...
the decade and radical-right populist parties are securing an increasing number of votes and parliamentary seats across the globe – a marked shift for the first time since WWII.

One leader who has managed to maintain his grip on power throughout is Russia’s Vladimir Putin, who has led the country since 1999! His efforts to reassert his global influence and return to superpower status have endured, but his attempts to revitalise Russia’s economy have languished.

**The rise and rise of China**

China delivered the most remarkable economic transformation in history over the past decade – transitioning from an emerging market to the second-largest economy in the world. Its large, successful companies such as Huawei, Tencent and Alibaba, have shown great innovation, expanding to now operate head-to-head with US giants such as Apple, Alphabet (then Google) and Amazon.

It is because of China’s rise and subsequent dominance that we expect global geopolitics to remain tenuous, despite the fragile trade truce reached with the US in January 2020.

**Climate change and the Greta effect**

Global concern for the environment grew through the decade. And when the teenage Swedish activist Greta Thunberg launched her solo climate protest outside her country’s parliament building in 2019, her defiant action sparked a global movement that established her as a powerful influencer on climate change and saw her being nominated for a Nobel Peace Prize.

The impact she has made in such a short time through lobbying political leaders and rallying her supporters is extraordinary. Now we need to see actual policy change that adequately deals with the significant challenges we currently face.

A clear illustration of the devastating impact of climate change must certainly be the Australian bushfires that have ravaged the country since September 2019. Governments around the world surely don’t need more of a wake-up call.

**Trust is Earned**

Of course, no reflection is complete without looking back at our own organisation over the past 10 years. Our purpose and passion have remained steadfast – not just in the last decade, but in the entire 26 years since we opened our doors. We help millions of people achieve their long-term financial goals – such as a better retirement. It’s a privilege we never take for granted. Our organisational values have stood the test of the ups and downs and continue to endure today.

Our role in uplifting communities through our CSI initiatives and ensuring that our own business reflects the demographics of our country are also deeply important to us.

And it is with great pride that I note that we finished this decade as we did the last, with very strong returns for our clients’ portfolios, continuing to show the strength and resilience of our long-term, active investment approach. The long-term track records across all our strategies have delivered meaningful value to our clients, with 97%1 of our institutional client assets experiencing positive outperformance since inception.

Figure 1 shows the long-term returns produced by Coronation’s flagship Houseview Equity Strategy since its inception in September 1993. As you can see, our active investment approach has resulted in investors earning 16.1% p.a.2 on their investment over this period.

This is an important consideration, given the massive and disruptive rise of index investing over the decade – most recent indications show that index investing now accounts for in excess of 50% of assets in the US, compared to less than 10% in 2010.

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1 as at 31 December 2019, funds with a 10-year + history.
2 Gross of fees
3 FTSE/JSE Capped Shareholder Weighted Index from 01 May 2017.
4 Previously S0 Low Resources (inception to 31 January 2002) and FTSE/JSE Shareholder Weighted Index (01 February 2002 to 30 April 2017).
Putting our clients first
During the decade, we showed in tangible ways how we prioritise the needs of our clients. An excellent example is when we closed our South African institutional book to new clients in 2012. This was the largest and longest close ever by a South African asset manager. It was a pre-emptive move to ensure that we did not take on additional client assets and impair our ability to outperform. We re-opened our strategies to new clients in 2017.

Going global
Another milestone during the last decade was welcoming our first global clients. Since launching our global franchise in 2008, we have established world-class track records across our entire range of global developed, emerging and frontier markets. All our global strategies, with a track record of more than a decade, have outperformed meaningfully since inception. We are pleased with the strong performance of our Global Emerging Markets and Global Equity strategies over 2019, which demonstrates the discipline maintained throughout the tougher performance periods in prior years.

Supporting black business and enterprise development
This decade, we made some significant strides forward in supporting black businesses in our industry. Pre-dating black economic empowerment legislation in South Africa, we pioneered a number of corporate initiatives that continue to contribute to transformation and the development of skills in our industry.

In 2006, we launched the Coronation Business Support Programme, a ground-breaking initiative to grow emerging black stockbrokers. We allocated a minimum of our South African equity brokerage to a group of black-owned stockbrokers annually. Since 2005, we have allocated in excess of R300 million in brokerage to programme participants. For both the industry and the companies themselves, the transformation has been remarkable.

In 2017, we also supported the creation of the first black-owned and managed administration business in the industry and the country, Intembeko Investment Administrators. Now in its second year of operation, Intembeko continues on its journey to become a world-class service provider.

Mapping out the landscape for the future
In President Ramaphosa’s New Year's message, he reflected that South Africa still has “many mountains to climb and many treacherous rivers to cross”. The hardships endure for South Africans and the low expected growth forecast for South Africa in 2020 is woefully inadequate if the country is to solve the triple challenge of unemployment, poverty and inequality successfully.

As we look ahead to 2030 and beyond, we are entering a decade – or even two decades – of lower expected investment returns. For the South African looking ahead across the years to their own retirement, what should their strategy be to thrive in this low-return environment?

Our nation desperately needs to develop a stronger culture of saving. And it will require behavioural change at the individual level. The key for any saver is to start to put money away for their future as early as they can. It is simply not possible to play catch up later in such a muted return environment. We will endeavour to educate South Africans through our various channels to help them understand the necessity and benefits of saving consistently over one’s life.

And of course, we are all hoping that the lights don’t go out permanently.

Another decade of gratitude
Thank you for your ongoing support over the years. We would not be here without you. I wish you a happy and successful year ahead and, in true Coronation style, a prosperous and positive next 10 years.

While, our country does not seem to be heading in the desired direction at this point and is a source of frustration and despondency for us, I am reminded of the timeless words of Dr Martin Luther King Jnr. – “If you can’t fly then run, if you can’t run then walk, if you can’t walk then crawl, but whatever you do, you have to keep moving forward.”

Sound advice for us all as we head into the next decade.

Good luck out there!

Kirshni
Demonetisation: India’s bolt from the blue

What did this programme really achieve?

by SUHAIL SULEMAN

THE QUICK TAKE

Demonetisation failed to punish beneficiaries of illicit activity/parallel market operators as intended

Constraints on withdrawals relative to immediate high deposits led to excess liquidity in the banking sector

Money market and similar instruments became attractive savings vehicles, with above-inflation interest rates

The demonetisation process indirectly caused some of the issues that led to defaults by some non-banking finance companies

IT’S BEEN JUST over three years since 8 November 2016 when, without prior warning, the government of India announced a cabinet decision that all existing Rs500 and Rs1 000 notes (then worth $7.50 and $15.00, respectively) would cease to be legal tender from midnight. In light of the deceleration of India’s economic growth rate and liquidity issues in its banking sector, it is worth revisiting the impact of this ‘demonetisation’ programme on the intervening years.

At the time of the announcement, the government also laid out the path forward to manage this exercise. The following day, 9 November, would be a banking holiday when no deposits or withdrawals would be allowed. From 10 November, all holders of these notes would have to deposit them into a bank account or exchange them for either smaller-denomination notes or a new series of high-denomination notes before the end of the calendar year. The old notes could be used for a short time for a narrow range of transactions, with certain public services such as healthcare and train fares listed as exemptions, but by and large, the soon-to-be defunct denominations were essentially useless to holders.

I’ve looked for data as to what proportion of the total value of outstanding notes these cancelled notes represented at the time, and there is a wide variety of estimates.

Evidence suggests that the cancelled notes represented about 25% of total notes in circulation by volume. However, since these were the two highest denomination notes in the country, they represented over 90% of cash currency in circulation by value. Reserve Bank of India (RBI) figures show that the total value of notes in circulation at the time of the decision amounted to $260 billion, so something in the region of $240 billion needed to be deposited or exchanged by the end of December 2016.

THE ELEMENT OF SURPRISE

A variety of reasons was given by the government for this drastic measure. Most apparent was the need to curb tax evasion by mainstreaming the...
shadow economy. In theory, this move would either spook tax evaders and other holders of illicit funds for fear of having to disclose their source of income, causing them to cut their losses, or the money would leave the shadow economy and enter the formal economy under the oversight of the banking system and tax authorities. Other reasons cited were along the same lines, such as halting counterfeiting activities and weeding out the proceeds of corruption.

Both individually and as a collective, the aims were laudable, but of course the true measures of success for any policy are, first, whether it achieves its targets, and secondly, the overall cost of implementation. Economists refer to the latter as a 'cost-benefit analysis', and it has been the subject of much debate in India as to whether this exercise was a success overall.

**THERE IS (ALWAYS) A WAY**

As mentioned, the government expected a material proportion of the cancelled bank notes to be of dubious origin and to leave the system permanently, as their holders would not be able to explain the source of funds. On this metric, the demonetisation drive failed completely.

The RBI estimates that 99.3% of total cancelled notes were either deposited or exchanged. This is an astonishingly high proportion, both in absolute terms and relative to government expectations of 80% to 85%. In discussions with bank executives with whom our investment team meets when in India, the common theme was that people found a way to deposit their illicit money.

The most frequent tactic was to divide large sums into smaller amounts that fell below the suspicious threshold, and then have several ‘friends’ deposit the money into their own accounts, to be subsequently withdrawn and returned to the originator for a fee or commission.

There were also reports of many businesses accepting the cancelled notes as payment for goods and services, since the businesses could then deposit the money under the pretext of having been in possession of them before they were cancelled.

**UNINTENDED CONSEQUENCES**

As could be expected in a society where more than 95% of transactions are cash, the demonetisation programme had quite an impact on ordinary citizens. Even with flawless implementation, it would have been difficult to avoid large-scale disruption – and the implementation was far from flawless.

In the days and weeks that followed, India’s national pastime became queuing at banks and ATMs to deposit money and withdraw new notes. The banking system was not prepared – there was an insufficiency of new notes and daily withdrawal limits meant that money deposited far exceeded the amount that could be withdrawn on a system-wide basis.

There was also a shortage of smaller-denomination notes, as most people did not want to withdraw Rs2 000 ($22.50) notes, which is a significant amount of money in a low-income country. Additionally, large notes are not readily accepted by merchants, many of whom found themselves struggling due to the lack of lower-denomination notes for their cash floats.

The temporary flood of liquidity into the banking system also had consequences. The shortage of notes and staggered withdrawal limits resulted in people ‘parking’ their money in fixed-term deposits or money market funds to get returns. Since one could earn interest rates higher than inflation in India (positive real rates), this made sense relative to withdrawing cash that earns nothing in the holder’s hands.

**A FATAL FLAW**

Much of this money found its way into the wholesale funding market, allowing India’s non-banking financial companies (NBFCs) to go on a lending spree just as the economy started to slow. One such NBFC, Infrastructure Leasing & Financial Services, defaulted on its debts in August 2018. The default was caused by poor lending practices and a mismatch between the long-term funding required for infrastructure and road projects, and the shorter-term nature of its borrowing book.

The default alarmed the market and led to a flight from the money- and wholesale-funding markets to regular savings accounts with banks, some of which was then withdrawn as cash. Other NBFCs have also since defaulted, most prominently Dewan Housing Finance Limited.

For now, the initial contagion seems to have been contained, but many of the weaker NBFCs have been forced to cut back on loan growth to preserve capital, as wholesale funding dried up for them, or at least was only possible at very high rates that squeezed their profit margins (net interest margins).

The recent slowdown in economic growth in the country is therefore partially attributable to the consequences of demonetisation.
THE OPPORTUNITY

A positive by-product of the programme was seen in some of the smaller private sector banks that our analysts assess. These banks had been investing in growing their branch infrastructure for several years in the hope of attracting a greater proportion of their revenue from current and savings accounts (CASA). A higher CASA ratio is desirable, since the average interest paid on these accounts is lower than other potential sources of funding.

Customers who deposit money in a bank are also more likely to make use of any retail banking offering available, take out loans or purchase other financial products.

A good illustration is Yes Bank, which was India’s fourth largest private sector bank at the time of the demonetisation exercise. In February 2016 (the financial year-end for most Indian businesses as it coincides with the tax year-end), CASA deposits made up 28% (see Figure 1) of Yes Bank’s total deposits. By the time end-February 2017 came around, just four short months after the recall, CASA accounted for 36% of total deposits.

At the time, management attributed the spike to a rush of deposits by new customers who opened accounts at any bank they could to avoid dealing with the chaos at the bigger banks. Further, the lack of notes and the economic slowdown that followed demonetisation meant the average duration of deposits was longer than originally expected.

Another private sector bank we follow, with a more established retail franchise, also saw a significant jump in its CASA ratio. Axis Bank’s ratio exceeded 50% for the first time in 2017 (see Figure 2), jumping 4% as a result of demonetisation-related inflows.

Figures 3 and 4 illustrate the impact demonetisation had on deposits and currency. Figure 3 tracks total deposits in the banking system and shows that there was a big spike in deposit growth when the programme started (it would have been even higher had no withdrawals been allowed), but collapsed completely thereafter as people were able to withdraw much of the money they had deposited.

Figure 4 shows how total currency in circulation collapsed before resuming its upward trend. This counters the argument that the programme would help the transition to a ‘cashless’ society over time.
BUT WAS IT WORTH IT?

Based on the evidence presented, it is my conclusion that the demonetisation exercise did not achieve what it set out to do, or certainly not what the government argued would be achieved at the time. When one considers the short-term disruption it caused to Indian society and the medium-term impact it had on the NBFCs, it is probably fair to state that the net impact on India was negative.

This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. Some of the companies mentioned herein were held in Coronation managed strategies as at 31 December, 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 above-mentioned 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.
2019 fourth quarter in review

GLOBAL HOUSEVIEW STRATEGY

2019 was a positive year, with the portfolio delivering double-digit returns and outperforming the benchmark. The major building blocks of the portfolio (global and domestic equity, and domestic bonds) performed strongly, with alpha in all of them further lifting returns. The portfolio has performed well against its peer group over meaningful time periods.

Global markets respond to stimulus

After a very weak fourth quarter of 2018, global equity markets rose strongly in 2019 in response to trade fears receding, combined with looser monetary policy in the US and Europe. The MSCI All Country World Index returned an incredibly strong 26.6% in US dollars for the year and 9% in the fourth quarter of 2019 (Q4-19). All eyes remain on US President Donald Trump as he stands for re-election in 2020 and the reverberating effect his policy will have on Chinese-American tensions.

The Bloomberg Barclays Global Aggregate Bond Index was up 6.8% in US dollars for the year and 0.5% in Q4-19. We remain cautious on global bonds given the very low yields at which they currently trade, high levels of government indebtedness and the risk of rising inflation.

Systemic woes remain a drag

In South Africa, the All Bond Index returned 1.7% for Q4-19, bringing annual performance to 10.3%. This compares favourably to other domestic asset classes.

South African investor confidence remains weak, as impatience has set in with the slow pace of much-needed reform. State-owned enterprises are fragile, with South African Airways entering business rescue in Q4-19 and the Passenger Rail Agency of South Africa placed under administration. The rebuilding of critical institutions is under way, with strengthened teams in place at the South African Revenue Service and the National Prosecuting Authority, and, most recently, the appointment of a new CEO at...
Eskom. The plight of Eskom remains concerning, as years of poor maintenance have resulted in an unstable power utility. Unplanned outages are very disruptive given the lack of spare capacity, and pose a major threat to economic growth prospects. The severe loadshedding experienced in December is expected to have taken a toll on retailers’ Q4-19 earnings. Growth continued to disappoint, with a contraction in both the first and third quarters of 2019. Low domestic growth and low inflation (3.7% CPI for 2019) should lead to rate cuts.

However, the South African Reserve Bank was reluctant to cut rates, believing that dovish monetary policy would have a limited impact given the high structural impediments to growth. As a result, real yields of South African bonds are at very attractive levels and local bonds therefore have a meaningful role to play in the portfolio. We are more cautious on domestic property, where we expect companies to struggle to show distribution growth over the medium term, as rentals that have benefited from high escalations for many years come up for renewal and are rebased to market.

The FTSE/JSE All Share Index (ALSI) returned 12% for the year and 4.6% for Q4-19. While this was a better year for South African equities, longer-term returns for domestic growth asset classes remain low (ALSI 6% p.a. and JSE Listed Property 1.2% p.a. over a five-year period). The JSE’s returns were boosted by the local resource sector, which performed strongly, overcoming fluctuating sentiment on global growth to finish the year up 28.5%. Industrials and financials were considerably weaker, delivering 8.9% and 0.6% respectively, with the higher domestic exposure of the financial sector weighing on performance. We continue to see value in South African-listed equities.

Within the Index, it was pleasing to see names that had detracted from performance in 2018 contributing strongly in 2019. Most notable among these were the platinum group metals (PGMs), with the portfolio’s holdings in Northam (+183% for the year and +47% for Q4-19) and Impala (+291% for the year and +51% for Q4-19) up particularly strongly. Other notable performers for the year include our global holdings with Quilter (+39%), British American Tobacco (+36%), Naspers (+23%) and Anheuser-Busch InBev (25%) also doing well. The portfolio’s underweight position in domestic businesses contributed positively, as the challenges of a lacklustre consumer environment and persistent structural cost inflation eroded earnings.

**Portfolio activity**

While our equity and balanced portfolios remain significantly exposed to offshore stocks, we have added to selected domestic holdings where we see value. Any near-term recovery in domestic stocks is likely to reflect a shift in sentiment rather than a dramatic improvement in earnings.

On the resources front, our large exposure to the PGM sector contributed meaningfully to portfolio performance for both the quarter and the full year. Platinum-group companies benefited from rising prices given growing demand (as emissions regulation requires higher vehicle PGM loadings) and a limited supply response. While we have cut our holdings into price strength, we still have meaningful exposure. Years of underinvestment in PGM mines mean that supply is unable to respond timeously. Significant capex with long lead times is required to change this.

Northam’s strength also reflected an easing of investor concerns on the overhang of the broad-based black economic empowerment (B-BBEE) deal funding, which becomes less dilutive at a higher share price. Another meaningful contribution came from the portfolio’s large position in Anglo American, which benefited from its ownership of Amplats (+149%) and Kumba Iron Ore (+65%). Both assets benefited from commodity price strength due to tight markets with an inability for supply response in the short term. We anticipate that the PGM deficit will be more enduring.

Sasol suffered a tumultuous year, collapsing on the back of further cost overruns relating to the Lake Charles Chemicals Project and a delay in its financial results. The board used this time to conduct a thorough review of internal controls and governance structures. Our underweight position during the year contributed to performance and we took the opportunity to add to the position at a time when investors had lost faith in the company. The previous joint-CEOs have now left the business and a new internal appointment has been made.

Additionally, the ethane cracker achieved its optimal run rate by year-end. The share has rebounded c. 20% off its recent lows. Risks in the company remain high and we continue to manage the position size carefully.

Within the financial sector, Quilter performed strongly in its second year of listing as the market bought into management’s vision of building a focused, integrated UK wealth manager. The reduced uncertainty in the UK political...
backdrop also helped. Naspers had a busy year with the unbundling of MultiChoice, the establishment of Prosus, an Amsterdam-listed entity that houses its international assets; the unbundling of a portion of Prosus (26%) to shareholders, and a bid for Just Eat, a multinational food delivery player. Unfortunately, the restructuring had little impact on the discount at which Naspers (and now Prosus) trade to their underlying holdings.

Given the capital allocation track record of management, we think the market is taking an overly pessimistic view on the discount. Due to the attractiveness of the underlying assets and the holding company discount, Naspers and Prosus constitute a significant holding in the portfolio.

Their major asset, Tencent, is growing rapidly in online payments and financial services, a market segment many times larger than the gaming market they currently dominate. While strong incumbents and the regulated nature of financial markets do increase the risk profile, the financial services offering has the potential to be a very large and profitable business.

British American Tobacco continued to deliver on its strategy, growing revenues (despite falling volumes in traditional combustible tobacco), widening margins (helped by cost reduction) and showing strong cash conversion, despite a changing regulatory environment. US regulators are becoming increasingly concerned over youth recruitment and the potential harm of alternative tobacco delivery methods like vaping. The magnitude of the threat posed by this category of the value inherent in some of the portfolio’s large holdings in the accounts comprising the Strategy may differ significantly from the securities that comprise the Benchmark. The strategy’s performance, but rather is disclosed to allow for comparison of the Strategy’s performance to that of a well-known and widely recognized Benchmark. Material facts in relation to the Benchmark are available here: www.msci.com/emergingmarkets.

The Strategy returned +13.0% during Q4-19, which was 21.4% ahead of the market’s return of 18.4%. This performance made it the Strategy’s best relative year since its inception almost 12 years ago (the previous best relative year was 2013 when it outperformed the market by 19.4%) and its third best year from an absolute return point of view, behind 2009’s +90.9% and 2017’s +40.7%. It has now outperformed the market over one, three, five, seven and 10 years, and most importantly, is ahead of the market over long time periods, with outperformance of 2.8% p.a. over 10 years and 4.2% p.a. since inception 11.5 years ago.

All the right moves
There were several stocks in 2019 that contributed more than 1% each to this outperformance and only one that detracted by 1% or more. In terms of positive contributors, Wuliangye Yibin led the way (appreciating by 161% and contributing 3.6% to performance), followed by New Oriental Education (+212%, +2.5% contribution), JD.com (+67%, +1.3% contribution), Yduqs/Estácio (+95%, +1.2% contribution), Yandex (+59%, +1.2% contribution), Adidas (+58%, +1.1% contribution) and Li Ning (+194%, +1.0% contribution). The good performance in 2019 was partly a reversal of a poor 2018 – three of the five worst performers in 2018 (JD.com, British American Tobacco and Cogna/Kroton) were all top 15 positive contributors in 2019, but it was also aided by a number of long-held positions coming through, including Yduqs/Estácio and Adidas referred to above. In addition, the likes of Airbus (+54%) and Sberbank (+59%) also contributed meaningfully.

Lastly, a number of more recent (calendar 2018) buys also played a large role, including Wuliangye, New Oriental and Li Ning. Of the seven largest positive contributors in 2019, we have totally sold out of one (Li Ning) as it reached our fair value, and we have materially reduced the position size of a few counters, including New Oriental (a 2.5% position in September 2019 to a 1.3% position December 2019) and Adidas (1.4% position September 2019 to a 1.0% position December 2019). In terms of negative detractors, it was only Taiwan Semiconductor (TSMC) that detracted by more than 1% (-1.1% impact). The Strategy did own TSMC, but the position size was smaller than that of the Index, and TSMC was a strong performer in 2019 (+62%).

Building exposure
There were four small new buys in the Strategy during the quarter (all 1% or smaller positions) and five sells to zero. In terms of new buys, we initiated positions in Tencent...
Music Entertainment (TME, 1% position), LG Household & Healthcare (LG H&H, 0.8% position), Midea and CP ALL (both 0.5% positions). In terms of sells, the Strategy fully sold out of Li Ning and China Resources Beer (+194% and +59%, respectively) during 2019, with both reaching and exceeding our estimates of their fair values. It also sold out of its remaining small positions in BB Seguridade after it reached fair value and Porsche, on the back of concerns about the long-term future of the traditional automobile industry. Lastly, it sold out of Cognizant, largely due to switching into its higher quality competitor Tata Consultancy Services, which was already a Strategy holding.

In terms of geographic exposure over the quarter, the only meaningful change was the reduction in the Strategy’s developed markets exposure (companies with at least 40% of revenue, profits or value coming from emerging markets), which went from 21.3% to 18.4% due to the sale of the Porsche position, as well as a reduction in the Adidas position. This 18.4% current exposure is largely in line with Strategy’s average developed market exposure of 17.8% in the Strategy since inception just under 12 years ago and well below the Strategy’s cap of 25% developed market company exposure. China remains the largest country exposure in the Strategy (32.3% but effectively 37% if the look-through Tencent exposure in Naspers/Prosus is included), followed by India (10.2%) and Russia (9.3%).

**Tencent Music Entertainment**

TME is 58% owned by Tencent and has two main businesses: a) it is the leader in online music in China, with around 75% of market share; and b) it has a large online social entertainment business, which focuses on music-related live streaming and online karaoke. The online music streaming business is the better of the two in our view and is essentially the Chinese Spotify, which actually owns an 8.6% stake in TME. TME have c. 650 million online music users in China (as a reference point, Spotify globally has a total of around 250 million users), but both the proportion of users who pay anything and the average revenue per user of those who do are low, and should increase over time and drive the top-line.

Today the business makes a small loss at the operating level, but with continued revenue growth and the resultant leverage of the cost base, in our view, it will be very profitable in years ahead. Content costs are cheaper in China than elsewhere globally (partly due to a fragmented music industry) and this should result in higher operating margins than the likes of Spotify, for example, are likely to achieve.

Currently, the online music business contributes c. 30% of TME’s revenue (and no profit) by our estimates, but over time we forecast that it will contribute c. 45% of TME’s revenue and c. 35% of its profits. The online social entertainment business (70% of TME’s revenue today and 100% of profit) is a very profitable business (earnings before interest and tax margins of c. 25%), but operates in a far more competitive area of the market where the barriers to entry are lower.

We still expect this business to do well going forward, but the jewel in the crown and the main driver will be the online music business, in our view. TME went public just over a year ago at $13 a share and we didn’t participate in the initial public offering (IPO) at the time. The Strategy has only ever participated in one IPO (JD.com) in its 11.5-year history as IPOs are almost always priced very favourably for the seller. After completing our due diligence on TME and gaining conviction, with the share price doing little since the IPO, we built the Strategy’s position one year later in December 2019 at an average price below $12. At the time of purchase, TME was trading on around 25 times forward earnings (c. 20 times forward price to free cash flow as the business converts c. 125% of earnings into free cash flow), which we believe is an attractive entry point for this asset.

**LG Household & Healthcare**

LG H&H is a South Korean-branded consumer company with c. 75% of profits coming from cosmetics and the other 25% from household personal care goods (similar to Unilever) and beverages (including the Coca-Cola rights in South Korea). The cosmetic business is the key driver and is what interests us most. The worldwide cosmetics industry has grown in excess of global GDP over the past decade (LG H&H has grown at between two and three times the industry), is economically resilient and is a prime beneficiary of the wealth effect and rising disposable incomes. This is particularly the case with the Chinese consumer and in this regard LG H&H is very well placed – today over half its sales come from the Chinese consumer (c. 15% in China itself and the balance from Chinese shopping, largely at duty-free stores in South Korea). LG H&H has been investing heavily in its main brand “Whoo” for the past decade, as it has been particularly popular among Chinese consumers. This is both a continued opportunity and a threat going forward. Over the past decade, LG H&H has grown revenue at
13% p.a. and earnings per share at 18% p.a., and today, the business generates a return of earnings (ROE) of c. 20%. The Strategy purchased LG H&H on c. 22 times forward earnings, which we believe is attractive for this high-quality asset.

**Midea**

This leading Chinese household appliances manufacturer has a 34% market share in washing machines in China, 24% in air conditioners and 15% in fridges. The company is vertically integrated (R&D, manufacturing, sales, warehousing and delivery) and is expanding into and developing logistics and robotics capabilities, as we increasingly move towards a smart technology world. While China (58% of sales) is its biggest market by far, it also generates revenue by selling in 200 other countries. Over the past five years, 110% of earnings have been converted into free cash flow and the business generates an ROE of c. 25%. In our view, the share is attractively valued today, trading on c. 14 times forward earnings with a 3% dividend yield.

**CP ALL**

CP ALL is the third largest 7-11 (convenience store) operator in the world (behind Japan and the US) with 11 500 convenience stores in Thailand (c. 80% of group profits) as well as over 100 cash and carry stores (Makro generates 20% of group profits). The business continues to roll-out c. 700 new 7-11 stores a year in Thailand, as well as increase the contribution from higher margin categories such as coffee, ready-to-eat meals and banking services within its stores. As a result, our view is that the business can continue to grow at a low double-digit rate in the years ahead.

In addition to its core Thailand business, it has nascent cash and carry operations in Cambodia, Myanmar, India and China, and is in discussions for the 7-11 Master Licence in Cambodia and Laos. Once a market darling, the share has been flat for the past two years and recent concerns about a potential bid for Tesco’s business in Thailand brought it into buying range.

**Year-end composition**

At the end of December 2019, the weighted average upside to fair value for the Strategy was around 30%. This is lower than the approximately 50% historical average; however, this is not abnormal after a period of strong absolute performance and we believe the absolute upside is still quite compelling. This is especially so when one considers that the quality of the companies owned in the Strategy is above average when compared to history.

**FRONTIER MARKETS**

Frontier markets are certainly no favourite. It is easy to see why, with the S&P 500 continuing to fire on all cylinders, delivering +31.5% in 2019 alone. Investors venturing beyond safe havens have not been rewarded. Outflows and fund closures, mainly in the Africa space, continue to impact the industry, with several funds winding down over the course of the year.

In this environment it is easy to forget that the shares in the portfolio are not simply numbers on a screen, but ownership stakes in actual companies. Have fundamentals changed? For many of the companies in our portfolio, the answer is: not much. They continue to grow, generating free cash flow and paying healthy dividends. Offering some insight, Table 1 below compares the fundamentals of some of the more meaningful positions in our frontier strategies to developed, emerging and frontier market indices.

It shows that the investee companies:

- Trade at forward price-to-earnings multiples well below broader indices;
- Have grown in line to well ahead of the indices;
- Have generated higher returns on equity than the indices; and
- Bar Zimplats, 2019 share price performance is vastly removed from the earnings growth and return on equity (ROE) performance of EICO, Egyptian International Pharmaceutical Industries Co. (EIPICO) and British American Tobacco (BAT) Kenya.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>COMPARISON OF FUNDAMENTALS ACROSS MEANINGFUL STRATEGY POSITIONS</th>
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<td></td>
<td>Country</td>
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<td>Portfolio company</td>
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<tr>
<td>EICO</td>
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<td>Zimplatz</td>
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<td>BAT, Kenya</td>
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<td>MSCI Frontiers</td>
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<td>Average</td>
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Note: BAT, Kenya is held by Africa Frontiers only; EICO is held by Global Frontiers only.

Source: Coronation

OUTFLOWS AND FUND CLOSURES, MAINLY IN THE AFRICA SPACE, CONTINUE TO IMPACT THE INDUSTRY.
With respect to Zimplats, the share price has increased significantly from a very low base; however, the company still trades on less than four times earnings.

All these businesses enjoy strong fundamentals, healthy growth prospects and incredibly attractive valuations, especially relative to some of the indices above. This is a rough measure, but when drilling into the portfolio that you hold, it quickly becomes apparent that it has been a year in which equity prices have declined or underperformed underlining company performance, and the upside to fair value for the portfolios has never looked this attractive.

Detractors

The main detractors and reasons for underperformance in 2019 can be grouped into the following categories:

Zimbabwe write-down (attribution: Global Frontiers -3.2%; Africa Frontiers -6.4%)

We have written at length about the decision and rationale to write down our Zimbabwe exposure. Despite the impact being incredibly painful and the main driver of this year’s poor returns, we continue to believe that the decision was prudent and protects investors in the Strategy. Any improvement in the transactability of the country should see strong improvements in our realisable values and performance. Unfortunately, as at year-end, an improvement has yet to be seen.

Index concentration (attribution: Global Frontiers -5.4%; Africa Frontiers -5.2%)

With respect to Global Frontiers markets, the MSCI Frontier Markets Index\(^2\) is dominated by Kuwait, which makes up 30% of the Index, and to which the Strategy has no exposure. Kuwait had a strong year in 2019 and returned 28.6%. This was a result of the MSCI announcing that Kuwait will be upgraded to emerging market status in 2020. Kuwait was the most significant driver of Index returns in 2019, accounting for c. 50% of its total return.

In the African Frontiers context, the FTSE/JSE All Africa ex-South Africa 30\(^3\) is dominated by the Egyptian bank CIB, which makes up 17% of the Index. CIB had a strong year in 2019, returned 59% in US dollars and accounted for c. 60% of the Index’s total return. The Strategy had exposure to QNBA, an Egyptian bank exposed to the same underlying drivers as CIB. QNBA trades at a 50% discount to CIB, despite delivering stronger earnings growth. QNBA is not in the Index and thus less widely owned than CIB. Over the year, QNBA returned 35% in US dollars and was one of the Strategy’s largest contributors (+2.2% contribution). However, the smaller position size and lower return relative to CIB still meant that CIB hurt our relative performance.

Divergence between valuations and fundamentals (attribution: Global Frontiers -2.7%; Africa Frontiers 3.0%)

In both strategies, several of our holdings have had very good years, reporting strong earnings growth and improved fundamentals. Unfortunately, share prices have largely ignored this and often declined significantly. BAT, Kenya (-1.2% contribution) is a prime example of this. Earnings were up 26% as at the end of the first half of 2019, and with the second half up against a flat base, the full-year numbers should be similarly healthy. Despite this, the share price fell c. 30% in US dollars and it now trades on an 8.9 times historic price earnings multiple and comes with a 9.0% dividend yield. Stanbic IBTC detracted (contribution Global -0.4%, Africa -0.7%) as the share fell 15% and EIPICO (-0.2% contribution, with the share down 13%). In the Global Frontiers Strategy, EICO detracted -0.9%, with the share down 6%.

This divergence between earnings growth or underlying business fundamentals and share prices is seldom cause for concern to the long-term investor. Over time, business fundamentals are what matter and a growing earnings stream in US dollars will result in share price growth. The key is to be patient enough to wait for this to happen.

In both Strategies, the largest contributor was Zimplats (+4.1% in Africa Frontiers; +2.4% in Global Frontiers), which had a very good year on the back of an increase in platinum group metal prices.

Global Frontiers Strategy

The past year has been a particularly challenging one for the Strategy, which increased 1.8% over the course of the year, underperforming the
MSCI Frontier Markets Index\textsuperscript{1}, which was up 18.0%. The year saw vastly divergent returns across the global frontiers universe, with equity markets in Kuwait (+28.6%), Egypt (+19.5%), and Kenya (+191%) all incredibly strong. Conversely Bangladesh (-18.4%), Nigeria (-14.9%) and Argentina (-13.5%) experienced a year to forget. Despite an incredibly disappointing 2019, the Strategy’s five-year and since-inception (1 December 2018) gross annualised returns of +2.8% p.a. and +3.0% p.a., respectively, are ahead of the Index’s respective returns of +2.7% and +1.8%. While these returns are well below our expectations, the Strategy is young, and we are very positive about its future.

Africa Frontiers Strategy
Our Africa Frontiers Strategy also experienced a particularly challenging year and declined by 5.6%. As a result, the Strategy underperformed the FTSE/JSE All Africa ex-South Africa 30 Index\textsuperscript{2}, which was up 16.5%. The Index was driven by strong returns in Egypt (+19.5%) and Kenya (+191%), with Morocco (+6.9%) and Nigeria (+14.9%) less impressive. Returns in Egypt were largely driven by strength in the Egyptian pound, while Kenya ended the year with a bang, rallying +17.2% in Q4-19, on the back of the interest rate cap repeal. Despite an incredibly disappointing 2019, the 10-year and since-inception gross annualised returns remain healthy, at +6.0% p.a. and +7.7% p.a., respectively. Despite 2019 being a torrid year, we have strongly outperformed the Index, which has returned +3.0% over 10 years and -0.3% since the Strategy’s inception on 1 October 2009.

The past quarter has shown improved absolute performance, with the fund up 6.3%. The FTSE/JSE All Africa ex South Africa 30 Index was up 76%. During the quarter, we added to Nigerian Breweries and IDH, while selling out of Cleopatra Hospitals and trimming our Safaricom position due to valuation concerns.

Outlook positive
With the challenges of 2019 front of mind, we are not underestimating the headwinds that might come our way in 2020. However, the one thing we have learnt is that the odds are weighted in the investor’s favour when you start the year with deeply discounted valuations for companies that are growing earnings strongly. We invest in thin markets, and capital flows exaggerate returns. 2020 certainly has the potential for a significant rerating, should there be any new flows to the asset class. Consequently, we are very excited about the year ahead. With the valuations of several high-quality businesses having reduced meaningfully over the past year, future returns should be healthy. 

\textsuperscript{1} Material facts in relation to this index are available here: www.msci.com/msci-emerging-and-frontier-markets-indexes.

\textsuperscript{2} Material facts in relation to this index are available here: www.jse.co.za/services/marketdata/indices/ftse-jse-africa-index-series/all-africa