corospondent

The Coronation Fund Managers Global Quarterly (US Edition)

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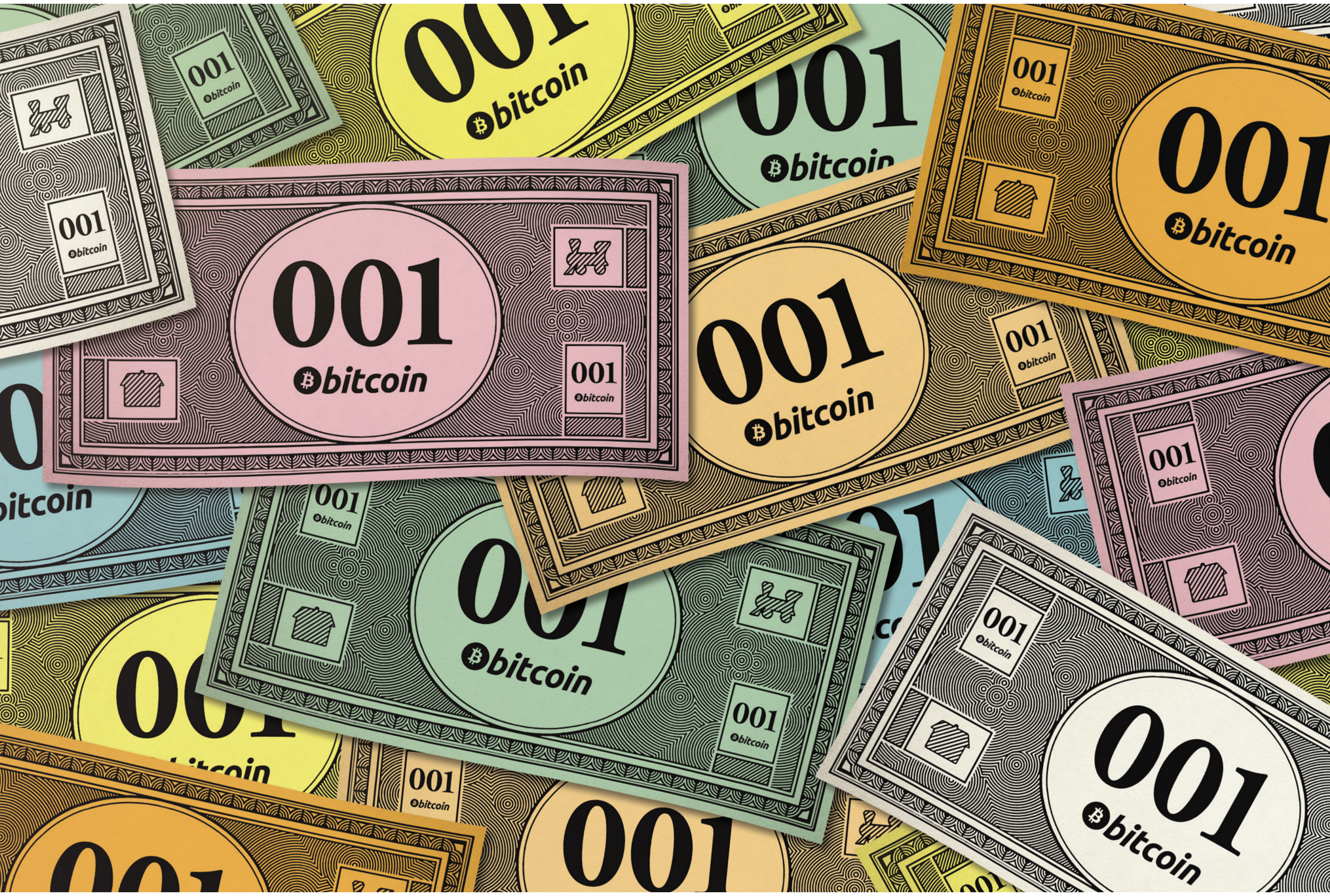

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NOTES FROM MY INBOX
TRUTH TO POWER

By Kirshni Totaram

Kirshni is global head of institutional business. She is a qualified actuary and a former manager of the Coronation Property Equity portfolio. Kirshni joined Coronation in 2000.

As we go to print, headlines could scarcely be gloomier. The barrage of bad news is unending, from nuclear threats, natural disasters, mass killings and raging corruption to alarming accounts of assaults against women in a supposedly progressive industry.

The accusations against Harvey Weinstein are depressingly familiar: powerful man harms women, finds shelter in misogynist culture of impunity. We see these dynamics play out with dispiriting regularity all over the world and also in South Africa. For most of history, women have not had equal access to formal structures of power. Far too often we are confronted with stories of women being objectified, stereotyped and discriminated against, and simply not having the same freedom as men.

I recently caught a glimpse of how this manifests in workplaces across the country. To commemorate Women's Month in August, Coronation held a number of events for clients and high-school learners. In South Africa, women have been at the forefront of the struggle for transformation. Yet the stories told by many women and girls reflected the systemic discrimination they face, the sometimes blatant but more frequently subtle sexism which is often reflected in a 'low inclusion' culture. At work, many experience prejudice and have been sidelined because they are not part of a male alliance or do not easily fit into a male-derived culture. At home, they shoulder many more unpaid hours of domestic work and care responsibility for an extended family network. What makes matters worse is that the wage gap is still painfully evident, despite how far we have come over the past 100 years. All of this has left many women disillusioned and exhausted.

I have been fortunate in my career to have found a home in an organisation like Coronation that fundamentally is premised on gender-neutral, race-neutral output. This has had a tremendous impact on my own personal growth and on my career. We remain determined to fight biases and equip all our staff (53% of us are female) with the tools to succeed, and the recent launch of the *Lean In* programme at Coronation forms part of this.

Unfortunately, all the programmes in the world will not eliminate gender discrimination and assaults against women and girls. We need more leaders – male and female – to use their power to advance gender equality and ensure power is no longer used against women.

IN THIS EDITION

This issue of *Corospondent* examines many of the deeply concerning geopolitical headlines that have dominated the news for some time. To give context and analysis, we turned to the chief foreign affairs commentator at the *Financial Times*, Gideon Rachman, for his insights. Inside is his exclusive assessment of the current crisis in Korea. A sobering read, he warns of the risk of nuclear attacks if the North Korean leader is faced with the prospect of the collapse of his regime.

While the global environment seems overcast, Europe is shakily emerging as an unexpected bright spot. Our economist Marie Antelme explores the reprieve granted to the continent after the latest round of elections, on page 8. She argues that Europe should embrace this window of opportunity for economic reform.

We know that Bitcoin is a hot topic. When a *Financial Times* headline reads, "Dimon and Fink unite on need to 'crush' Bitcoin", you know that the topic has taken on supernova status. On page 6, Neville Chester dissects and destroys the investment case for the current batch of cryptocurrencies. While we remain excited about the possibilities of blockchain technology and expect a reputable digital currency soon, we do not believe one of the current contenders will survive.

There is no shortage of *true* investments in this edition, and we include analysis of the South African retail group Spar and of Airbus, the European aircraft manufacturer. Airbus has long been an unloved stock and may look like an unexpected addition to our portfolios, especially our Global Emerging Markets Equity strategy. But our extensive research shows that Airbus is trading well below our estimate of its fair value, and that the company has a long runway (yes, pun intended) of growth. As an emerging market company, we also understand the potential demand for its products outside the developed world.

We believe this homegrown perspective on emerging markets provides us with a competitive edge in investing across the globe. We see the world from a different perspective – where others may only see risk, we have successfully identified long-term opportunities over the years. As the world economy evolves, we believe that an allocation to emerging markets is becoming increasingly obligatory.

We hope you enjoy the read. ■

Kirshni

FEES SLASHED ON SOME OF OUR STRATEGIES

SAFEGUARDING COMPELLING RETURNS

By Kirshni Totaram

Kirshni is global head of institutional business. She is a qualified actuary and a former manager of the Coronation Property Equity portfolio. Kirshni joined Coronation in 2000.

As part of Coronation's ongoing commitment to ensure the best outcome for clients, we continually review the charges on our products to make sure they reflect market conditions and offer compelling value to clients.

We are an active management house that aims to materially grow our clients' portfolios by outperforming the market on a consistent basis over the long term. This is evidenced by Coronation's almost 25-year track record of persistently outperforming the market.

It is in this light that we have made some bold changes to the fees in many of our top-performing strategies, which we believe will benefit our clients and safeguard compelling returns for years to come. We have cut fees by up to 15 basis points on many actively managed equity and multi-asset class strategies. This includes our successful Global Emerging Markets Equity strategy, which has delivered outstanding returns since inception. All current clients have benefited from this move.

In addition, base fees on our performance fee options have reduced in line with fees on available passive solutions. We believe that this is a powerful move that offers investors only upside in terms of the costs they pay for our products and have an outsized benefit if we deliver outperformance over the market. We only earn higher fees if and when we outperform.

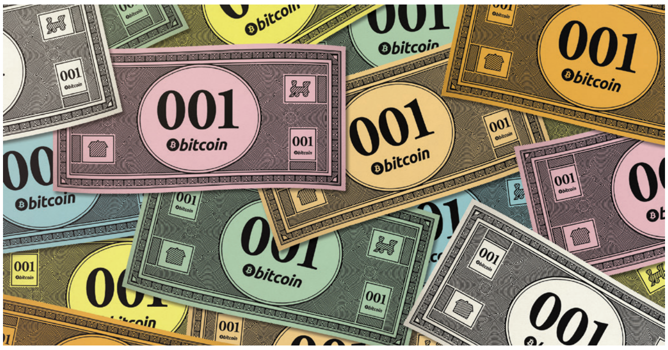
PIONEERING A CHANGE TO HEDGE FUND FEES

Coronation has taken a bold step in changing the fees on our hedge funds – making us a global pioneer with this move.

Coronation has always been outside of the norm by charging a performance fee only above the risk-free cash rate (many hedge funds charge fees over zero).

Along with a reduction in the performance fee participation rate, we have taken the bold step of capping the annual performance fee on our hedge fund portfolios from 1 October 2017. This is a pioneering approach in an industry that has traditionally never put caps on fees. We have introduced an annual performance fee cap for the Coronation Presidio Long-Short Equity Hedge, Coronation Multi-Strategy Arbitrage Hedge and Coronation Granite Hedge strategies.

As you know, Coronation is an owner-managed and investment-led firm. Every decision we make is driven by the sincere desire to deliver strong investment outcomes for our clients. We have demonstrated this client centricity over the years, time and time again. The latest fee reductions should confirm this commitment. For a more detailed breakdown of the fee changes, please contact your client service fund manager. ■



THE BITCOIN BUBBLE

BUT THE FUTURE OF BLOCKCHAIN IS BRIGHT

By Neville Chester

Neville is a senior member of the investment team with 20 years' investment experience. He joined Coronation in 2000 and manages Coronation's Aggressive Equity strategy.

When is a bubble not a bubble? When it is a new paradigm, of course! Throughout history, every time a bubble gathers momentum, there has always been a strong and often logical (though not always) explanation for why there was no bubble. Towards the end, the defenders become louder and more assertive against the naysayers, until it all comes crashing down.

Bitcoin was recently described by Jamie Dimon, the CEO of JP Morgan, as a "fraud". I prefer the term used by the *Financial Times*: "mass delusion". A fraud implies a conscious effort by a group of individuals to steal money from another, whereas what we see with Bitcoin is not that.

I would, however, categorise the raft of 'Initial Coin Offerings', or ICOs as they are referred to, as something more akin to fraud. Increasingly companies, in a completely unregulated fashion, are launching myriads of copycat 'coins' in the hopes of raising cash from gullible participants who are hoping to cash in early on the next Bitcoin.

But we are getting ahead of ourselves. Some non-millennials might be asking: what is Bitcoin? Bitcoin is a virtual currency which was launched off the back of a new advance in technology called blockchain.

The key attribute of this technology, and what makes it such a potential game changer, is that the record of ownership is contained in a distributed ledger. This allows independent verification that each Bitcoin is indeed unique and not simply a virtual copy. The way Bitcoin was constructed also ensured that there would be a limited supply of Bitcoins (21 million, if you're interested), creating a 'rarity' of supply – important support for the value of any commodity.

In any debate about investing in Bitcoin, zealous promoters will argue 'blockchain' back at you, usually with some comments about how old-school finance is going to be undermined by blockchain in the future and why many established bankers and economists do not believe in Bitcoin because it is a competitor to their existing interests. This is unfortunately confusing two concepts. Blockchain is indeed a revolutionary technology and it will redefine our future relationships with many financial institutions. The ability to independently verify ownership of any asset without the use of an intermediary is very powerful. This is why the biggest investors in exploring the technology of blockchain are the big financial institutions. Bitcoin, however, is just a product launched using the blockchain technology. One of thousands, in fact.

A supposed benefit of cryptocurrencies is that they are presumed to protect your assets from central banks which are printing fiat money at a rapid rate post the financial crisis. However, today there are over 1 000 cryptocurrencies in existence (including the humourlessly named Titcoin, used in the adult entertainment industry) against around 180 fiat currencies. And the list is growing every day.

Is Bitcoin a currency? A functional currency has two key attributes:

- It is a store of value.
- It is a medium of exchange.

Given the extreme volatility we have seen in Bitcoin prices, it fails the first test. It also largely fails the second, despite a number of vendors being prepared to accept it. The reality is no one is actually pricing their goods in Bitcoins; they price them in dollars or an equivalent fiat money and then accept payment via Bitcoin. This is due to the first point: the valuation of Bitcoin varies wildly from day to day.

The majority of transactions that Bitcoin is being used for are speculative trading, circumvention of capital controls in countries like China and Venezuela, and for concluding other illegal transactions. The settlement time is also prohibitively long for effective day-to-day transactions. It can take up to an hour for transactions to be confirmed as valid. This is not a realistic scenario while waiting in a queue at your favourite store.

So is Bitcoin an asset and can you invest in it? The fundamental step is to determine the value of a Bitcoin.

And here even the most messianic of Bitcoin promoters cannot come up with a fundamental basis for what the value of a Bitcoin could be.

The reason is that the basis for any valuation is ultimately a discounted cash flow of the return the asset generates. Whether valuing a government bond, a property or a company, the value of the asset is determined by the value of the cash flows the asset will ultimately generate. And Bitcoin generates nothing. It is a speculative investment in that the value of a Bitcoin is determined only by the price someone else will want to pay for it.

This is why the punters of Bitcoins and other cryptocurrencies are so fervent in spreading their message: the more people are buying it, the greater the chance of selling it for a profit. When fewer people buy it, the likelier the chance of a loss.

Without a doubt, the current situation of quantitative easing has facilitated the growth in cryptocurrency bubbles (and many other asset price bubbles).

While interest rates have been held artificially low, the cost of speculating has been very low. If you can borrow money cheaply, your opportunity cost of buying assets with no yield is low. However, as interest rates start to normalise, as in the US currently, with murmurs also growing louder from the UK and Europe, the implied cost of holding an asset that generates no yield will rise.

The future of blockchain is bright and in all likelihood, some time in the future, we will see central banks adopt and promote a virtual interchangeable version of digital currency, but one that will be stable and traceable to prevent the facilitation of criminal activity. It will not be Bitcoin. ■

EUROPE'S REPRIEVE

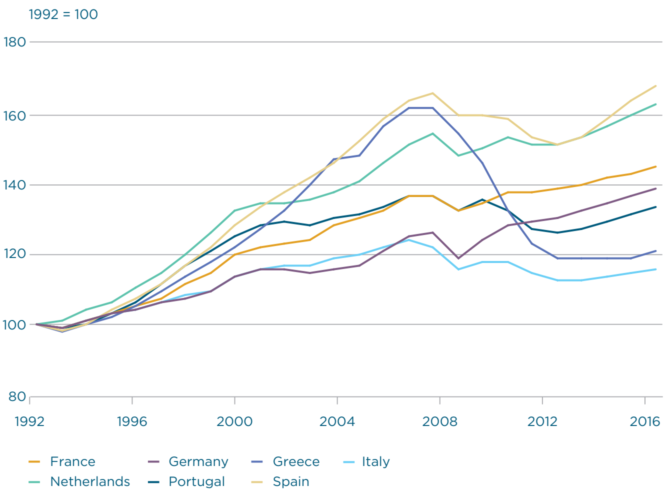
BUT GERMANY NEEDS TO DO MORE

By Marie Antelme

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

Europe has been the big surprise this year. Reeling from the unexpected decision by the UK to leave the EU, and Donald Trump's election win in 2016, it was hard *not* to expect a populist victory in a vulnerable Europe in 2017. Many in Europe have suffered deeply during a decade of slow recovery, and economic hardship has contributed to political outrage, especially against outsiders. Concern about populism was even more pronounced because the global financial crisis, followed by the Eurozone sovereign debt and banking crises, had already triggered a crisis of confidence in the EU and its monetary union. Against this background there was very real concern that the emergence of populist political parties would be the death knell for a weakened Europe.

RELATIVE REAL GDP GROWTH



Source: IMF

In Europe, populist parties on both sides of the spectrum have been more visible, more vocal and perhaps more entrenched than in either the US or the UK. The election calendar in 2017 was also unusually packed, with each country's own populist politicians proposing various, and sometimes extreme, alternatives to the status quo. Still, most offered a common anti-immigration narrative, forcing centrists to adopt it as an electoral issue. The economic implications seemed bleak. And as the polls ahead of the Brexit vote and US election were so misleading, nervousness grew about an adverse outcome in at least one of the elections.

ELECTION RESULTS

The first key European country to hold elections this year was the Netherlands. It has a rather complex electoral system which allows for a broad level of representation in the Binnenhof. Coalitions are common, and it seemed unlikely that populist firebrand Geert Wilders of the Party for Freedom (PVV) would gain a ruling majority. Nonetheless, his strong views on immigration were widely telegraphed, especially since the Netherlands is traditionally one of the more tolerant EU members. Wilders' campaign called primarily for the de-Islamification of the Netherlands and more sovereign independence, "including from the EU". On the day, the PVV gained the second-most votes, but failed to attract a meaningful coalition partner.

The elections in France were perhaps the most important and least certain. Emmanuel Macron, running as an independent, campaigned for wide-ranging economic reform and a strengthening of relations with the EU. The campaign of the Republican nominee, François Fillon, was plagued by controversy. But their challenger, the established anti-EU populist Marine le Pen, remained consistently popular in the run-up to the election. Macron's victory not only secured him the presidency, but his new party, La République En Marche, gained the parliamentary majority. A resounding victory for French Europhiles, with a mandate for much-needed labour reform within France.

It was supposed to be the most predictable election of the year that ultimately sprung the biggest surprise. The outcome in Germany confirmed that Europe has only seen a political reprieve and not resounding support for moderate politics. As expected, Chancellor Merkel won her fourth term, but there was a significant shift in underlying political dynamics. Instead of a Grand Coalition, Merkel will have to rebuild her coalition with liberal alliances. There is also now a blemish on the political landscape with a swing in support towards the right-wing populist Alternative for Germany (AfD). Again, centrist candidates lost support due to immigration concerns.

While the electorate supported European unity, it is clear that deep divisions remain, specifically regarding immigration and fiscal union, and these are close to the surface. Nonetheless, diminished political risk, surprisingly strong European growth momentum, recovering labour markets and a supportive global context are serving a potent cocktail for Europe.

GDP growth may remain comfortably above 2% this year, and is expected to stay at about the same rate in 2018. With unemployment in Europe (currently 9.1%) at multi-year lows and further support for a tightening labour market, there may be a cyclical opportunity to integrate further, to bring Europe from an "imperfect monetary union to a true economic continent" (according to the French finance minister Bruno Le Maire). But the opportunity is more likely to be a window than a door.

EUROPE'S OPEN FLANKS

The path to closer European integration is full of obstacles, on all flanks:

Economic flank: closer fiscal union

This is arguably the biggest risk factor for the EU. The current monetary union lacks key features crucial for long-term stability, above all greater *fiscal* union at a centralised level. Members have given up their exchange rates, but the failure to further unify their fiscal policies has weakened the union's ability to react to shocks. Unfortunately its most powerful (and fiscally conservative) members have weakened the move towards a sufficient centralised fiscal policy. Without it, the EU remains hamstrung in tackling future challenges.

Political flank: immigration

The immigration crisis of 2015 revealed that Europe fundamentally disagrees on immigration politics, which has emerged as a poisonous and divisive political narrative.

No unified vision for Europe

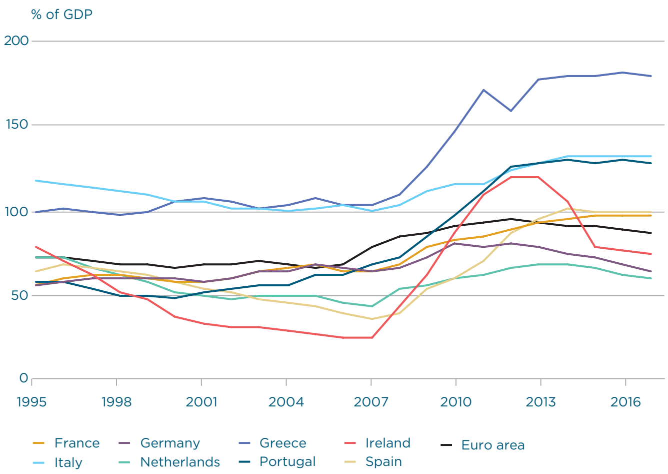
The aforementioned economic and political weaknesses are compounded by a lack of common vision. This, in turn, has led to the emergence of political alternatives in Hungary and Poland that have been moving very far away from the political centre. A new agenda needs to provide potential areas of cooperation, to ensure focus and build momentum.

CONTINENTAL DIVIDE

A first step in rebuilding the European project is recognising the deepening divisions, inequality and ongoing economic hardship following the global financial and European crises. This has undermined trust in EU institutions, threatening the broader European identity and terminating integration efforts. Countries which had to be bailed out have suffered slow and painful economic transitions. The process has deepened the North-South economic and political divisions, and reinforced the dominance of the stronger countries in institutions and policymaking. Externally, immigration, terror threats and attacks, a re-emergence of national identity and concerns about East-West geopolitical uncertainty all challenge the existing framework.

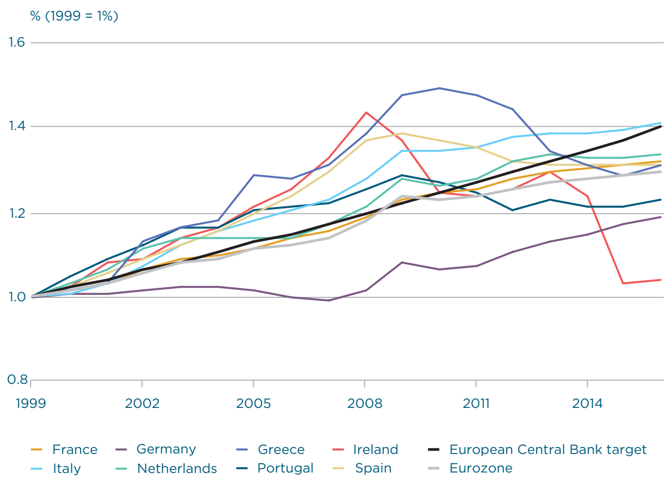
Germany, the biggest economy within the EU, has benefited enormously from conservative policies in the period between 2002 and 2009, especially in the labour market, and after that from the weaker euro. Germany is running a current account surplus at a breathtaking 8.6% of GDP (at the end of 2016), and growing at 2.1% year on year, above its estimated long-term potential. Germany has low government debt to GDP (65%) and is running a small fiscal surplus. It also has the loudest voice in EU decisionmaking.

GROSS DEBT



Source: IMF

EUROPEAN WAGE GROWTH



Source: UBS

France's position has been largely overshadowed by Germany, but regional momentum and revived hope of reform and stronger growth have boosted its GDP to 1.8% year on year. France's debt levels are high at 96% of GDP, and its deficit is persistent at -2.8%. But for the first time in years, French confidence is on firmer ground and Macron has a very real opportunity to reinvigorate the economy. Credible domestic reform will also boost France's ability to promote a reform agenda to Europe.

The so-called 'European periphery' – Ireland, Spain, Portugal and black-sheep Greece – saw their domestic financial systems buckle under massive debt burdens. In Ireland and Spain, private debt and poorly regulated banking systems were the root cause, while in Portugal and Greece profligate fiscal policy during the boom saw deficits bulge and debt rise. All suffered ballooning current account deficits as debt increased. As the crisis hit these vulnerable economies, the bailout of the banking systems led to a sharp rise in an already large stock of debt. All four sought financial assistance.

Through a painful adjustment, Ireland exited its reform programme, and has managed to recover. The other three are taking longer to recuperate. Still, economic stability in Spain has improved meaningfully, and Portugal too is on a firmer footing. In Greece, the fiscal interventions required to stabilise the sheer burden of its debt has left the economy in an almost semipermanent recession. The situation has become so dire that eight years into its reform programme and seven prime ministers later, the EU and IMF are at loggerheads about how to proceed. The IMF is advocating debt relief for Greece, while the EU, which has already lowered debt service and extended the repayment periods for Greek debt, is reluctant to do more.

THE WAY AHEAD

At this stage, France offers the best options for a new integration agenda. France's proposal, presented by Macron at the Sorbonne in late September – after the German election – stated explicitly the need for Europe to consolidate against the present threat of populism. Macron called for "the refoundation of a sovereign, united and democratic Europe". Amongst his wide-ranging proposals were a bigger EU budget to fund investment and provide a cushion against shocks, a simplified European Commission, an EU intervention force with a unified frontier police force, educational initiatives across EU institutions, funding for innovative research and an overhaul of agricultural policy. He fell short of directly proposing a European Monetary Fund with oversight by a single finance minister, but has mooted these in the past. The importance of these proposals is twofold. France, by implementing tough reform at home is claiming its place as a significant driver of EU integration. Also, by offering a wide-ranging menu of reforms, Macron gives Europe options to choose a path forward.

Earlier this year, the European Commission released a report that called for more efficient economic structures, a financial union (including a banking union and a capital markets union), a fiscal union which will promote fiscal sustainability and stabilisation and, ultimately, a political union with democratic accountability, legitimacy and stronger institutions. The report sees these unions slowly evolving in parallel. However, it acknowledges that short-term measures need to be ambitious in order to be meaningful.

The challenge, as always, is getting it done. Of the bigger, more influential European economies, only France really has presidential commitment, with adequate domestic backing, to push the reform agenda. And that is not enough.

STRONGER TOGETHER

It is possible that economic reform in France will see a strong economic revival. President Macron has already implemented labour reform that will go a long way to addressing France's economic malaise. In doing so he is supporting regional growth, boosting confidence, reinforcing credibility and creating a platform for a new debate on European integration.

But what Europe really needs is for Germany to set aside its fiscal conservatism and take responsibility for the union and the role it plays. It needs to make a bigger economic commitment to the stability of the EU. Unfortunately, Germany's election outcome does not give much hope – despite the possibility of a more liberal, pro-Europe coalition, Germany remains fiscally conservative.

For many young Europeans, their only experience of being part of the EU has been miserable – high unemployment, fiscal constraints, poor wage growth, ongoing risk of economic crisis, banking fragility, systemic risk and external threats to their safety. There is a major risk that these voters opt out rather than integrate if nothing changes. Stronger economies may help counter the risk, but current growth will be put to the test soon: the next two years bring a host of fresh elections to the European calendar. If current growth falters, this optimism fades. ■

THE KOREAN CRISIS

ONE MISSTEP AWAY FROM CATASTROPHE

By Gideon Rachman

Gideon is the chief foreign affairs commentator at the Financial Times *and a globally respected journalist. He joined the* Financial Times *in 2006 after a 15-year career at* The Economist, *which included positions as a foreign correspondent in Brussels, Washington and Bangkok.*

After years of rumbling away in the background, North Korea has pushed its way to the very front of the international agenda. The North Korean regime led by Kim Jong Un is closing in on developing a nuclear missile that can hit the United States. But Donald Trump has vowed that North Korea will not be allowed to threaten the US with nuclear weapons. The US president has also repeatedly suggested that the US is prepared to take preemptive military action to prevent this from happening. Speaking at the UN, he even threatened to "totally destroy" North Korea, if it threatened the US.

Some sort of final crisis may now be in the offing. The Chinese government has compared the US and North Korea to two trains heading towards each other, at top speed. The question is whether either side is prepared to slam on the brakes.

It is highly likely that there are secret diplomatic contacts between Washington and Pyongyang – so the crisis could yet be resolved by negotiations. Alternatively, if North Korea is ultimately unwilling to freeze its nuclear programme, the US might indeed stage a military strike. But the strongest possibility is that America will ultimately decide that attacking North Korea is too dangerous – and will finally have to tolerate the North Korean nuclear threat.

The Americans know that any attack on North Korea could spark devastating retaliation against South Korea – and against US military bases in the region. North Korea probably now has more than 20 nuclear weapons – and they are dispersed in secret locations. Even if the US succeeded in 'taking out' all of North Korea's nuclear weaponry, the Pyongyang regime could still launch a devastating conventional artillery attack on South Korea, whose capital, Seoul, lies just 56 km from the North Korean border. American estimates suggest that up to one million Koreans could die if war broke out on the Korean peninsula.

North Korea is such a closed society that even academic specialists struggle to interpret its behaviour. The mainstream view is that Mr Kim's pursuit of advanced nuclear weapons is motivated by a search for security.

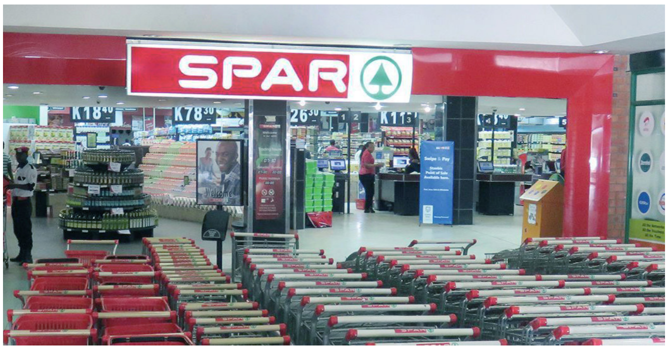
The North Korean leader has seen what happened to other dictators who failed to acquire these weapons – Saddam Hussein of Iraq and Muammar Gaddafi of Libya – and concluded that only nukes can guarantee his survival. North Korea would also be devastated by American retaliation – if it was unwise enough to attack US bases in South Korea, or elsewhere.

For that reason, it seems unlikely that either side actually wants a war. But it remains possible that North Korea and the US will stumble into a war by accident. The two key leaders – Presidents Kim and Trump – are both unpredictable and given to bombastic rhetoric. The dangers that they will miscalculate each other's actions – with catastrophic consequences – are real.

The Chinese government, North Korea's neighbour, is critical to hopes of a peaceful solution – but faces a complex set of calculations. Mr Trump has repeatedly tried to persuade Beijing to exert more economic pressure on North Korea, threatening that the US will take unilateral military action if China fails to force Mr Kim into line. China has sought to placate Mr Trump by toughening sanctions on Pyongyang. But the Chinese also have to consider how Mr Kim might react if he is forced into a corner. The risk that the North Korean leader will use nuclear weapons first will surely rise if he is faced with the prospect of the collapse of his own regime – and his own certain death.

It is also important to be realistic. The Kim regime currently shows little interest in diplomacy, or in responding to the tentative efforts at rapprochement from the new South Korean government.

For the moment, therefore, the world will have to trust in deterrence, containment and luck to avoid a catastrophe on the Korean peninsula. ■



SPAR
DUSTING ITSELF OFF

By Tumisho Motlanthe

Tumisho Motlanthe joined Coronation in 2007. A CFA charterholder, Tumisho researches South African retailers and food producers, as well as hotel and leisure companies.

Alfred Pennyworth: *"Took quite a fall, didn't we, Master Bruce?"* Thomas Wayne: *"And why do we fall, Bruce? So we can learn to pick ourselves up."* – Batman Begins (2005)

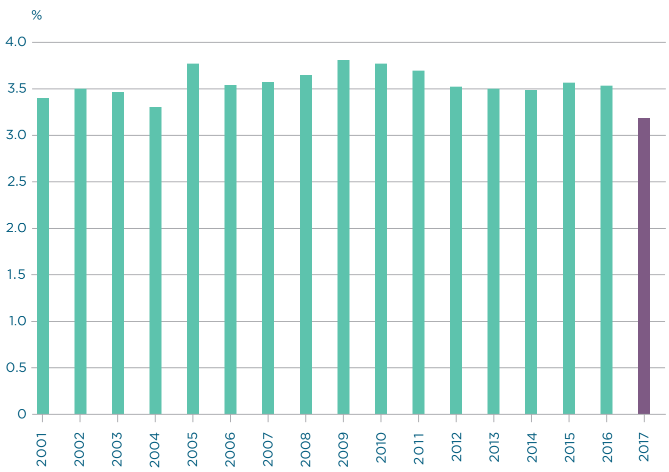
Four years ago, when we last wrote about Spar South Africa, the company had just turned 50 years old. Having faithfully served its communities throughout the decades, and handsomely rewarded investors since listing in 2004, the business and its share price were solid outperformers ... until about a year ago. From a high of R219, the share has tumbled nearly 25%, with the stock now having underperformed the market over the last five years.

Recent earnings have disappointed and some valid concerns are being raised around Spar as an investment. We too have wrestled with these concerns, and having concluded that the challenges are surmountable, we explain our thinking in this article.

IS PARADISE (REALLY) LOST IN SOUTH AFRICA?

In the six-month period to end-March 2017, Spar South Africa reported its lowest ever operating margin of 3.11%.

SPAR SOUTH AFRICA EARNINGS BEFORE INTEREST AND TAX

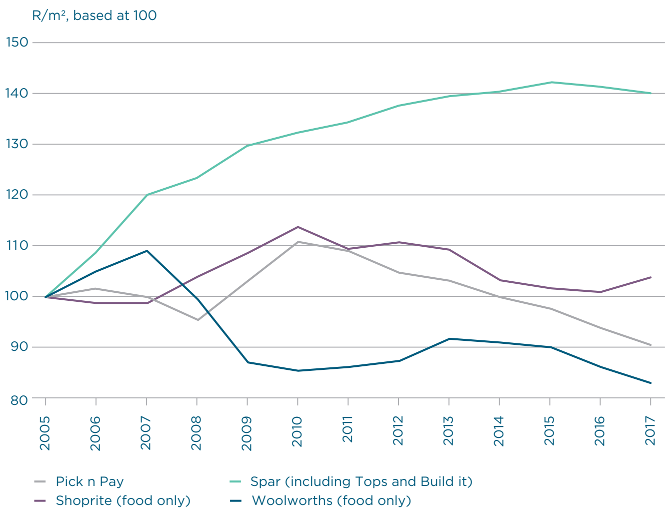


Source: Company financials

This was a shock to the market and to us. Here was a business that, with metronome-like regularity, delivered 3.5% as a matter of course. While a difference of less than 0.4% may not sound like much, it is actually a 10% reduction in profitability levels – on margins that are already this thin! Compounding this was the fact that total revenue had declined in real terms, driven by a 5% decline in volumes through the retailer's distribution centres.

The following graph shows the evolution of retail space productivity in real terms, relative to 2005. What is clear is just how well Spar has managed this. Over the last two years, however, it has been declining, due to a number of reasons. First, Spar's excellent execution over many years has built a high base. Importantly, the economy is much weaker and consumers are very distressed. In addition, Spar is experiencing challenges with its business model. While the economy should recover eventually, the big fear is that Spar's model may fall down.

SOUTH AFRICAN SUPERMARKETS: REAL TRADING DENSITY



Sources: Company financials, management guidance, Coronation estimates

We have spent a lot of time speaking with various people in the organisation as well as outside of it (competitors, suppliers, franchisees), thinking through these issues and contextualising recently reported numbers against long-term history. These channel checks have provided invaluable insight into the business model. We believe the model will withstand current pressures and that the market's fears are overdone.

Some of the factors we considered are:

- **Loyalty of franchisees.** Given the current difficulties, some of Spar's independent franchisees are currently weighing up the pros and cons of staying or leaving. Though it might be tempting to exit the agreement, the costs would almost certainly outweigh the benefits:
  - Being a member is financially lucrative. Spar carries the stock burden, so franchises have become a lot more cash generative over time. Ten years ago, its creditor days (the average time a company takes to pay its creditors) were at parity with stock days (the average number of days the company holds its stock before selling it). Now, creditor days are twice as long.
  - Spar's systems and processes are easy to use, freeing up franchisees from having to deal with suppliers and investing in fleet.
  - The transparent nature of the agreement with Spar engenders trust. Franchisees can easily compare it with that of competing retailers. Spar suffered only a single defection in the last year – the agreement is evidently compelling.
- **Limited threat of independent buying groups**. As beneficiaries of down-trading over the last few years, these retailers have managed to increase their market share. However, they are unable to effectively compete for Spar's customers in two key categories: fresh food and prepared/convenience meals. This limits their ability to entice Spar's franchisees away en masse, which lowers the risk of Spar being replaced as the wholesaler of choice.
- **Coordination of retail strategy**. Because the agreement between Spar and its franchisees is voluntary, it is no surprise that execution varies from store to store. This has resulted in differences in what customers find on shelves and in terms of the services offered (even within the same format), and has added to the difficulty of drawing new customers into their stores. Management has now confirmed two big, compulsory initiatives for all franchisees:
  - Money market counters and kiosks are part of the South African customer experience. These provide another reason for consumers to enter the store and two additional opportunities (sending money and receiving money) for Spar to build a long-term relationship with the customer.
  - The 'My Spar Rewards' programme has to be very visible in-store. The programme is being heavily promoted after Spar historically undervalued the importance of loyalty programmes.
- **Price perception set to improve.** Consumers wrongly view Spar as expensive, regardless of the store format. The company's previous marketing campaigns have not shouted loud enough about price. Future campaigns will see more price-focused advertising that clearly highlights how much consumers can save. Across the stores, all franchisees are now also running off a single point-of-sale system, which will allow promotions to be pushed seamlessly across the stores.
- **Space growth.** Spar's recent store roll-out has been slowed due to the weak environment. Franchisees have grown skittish about opening stores, while new property developments have been delayed. The company still has a healthy pipeline of new sites in areas where they lack a presence, and this will come on-line in the near to medium term.
- **Sustainable profitability.** We believe Spar's long-term profitability is higher than that reflected in today's margins. Operating costs have outgrown revenue, gross profit margins declined and volumes were negative – all simultaneously for the first time. Not the usual service we have come to expect over the years! In fact, volumes have never been negative over a full 12-month period. Pleasingly, volumes have picked up even as food inflation has come down, and there is every chance that volumes will finish the year in the black. Given Spar's largely fixed-cost base, this improvement suggests great potential for fatter margins in future. We expect 3.5% may be sustainable in the foreseeable future.

Once the environment stabilises and starts to improve, Spar should be off to the races. We expect the business to return to at least maintaining (and even growing) its retail space productivity. Along with the normalisation of margins, the earnings recovery should be strong off what we believe is a low South African earnings base.

EUROPEAN ACQUISITIONS

In recent years, Spar bought related retail businesses in Ireland, South-West England and Switzerland. Were these European acquisitions a mistake?

We think the acquisitions were strategically important, and see them as a natural extension of the business, given the limited scope for big store roll-out in South Africa as the group protects franchisee profitability. All the European businesses work on the same model as in South Africa, and in fact three of them are Spar licensees in those countries. In our view, management is staying within its circle of competence, reducing the risk of the acquisitions. Some R2.1 billion has been spent on these acquisitions and, seeing as they were acquired on price/earnings multiples of between seven times and 14 times, with good earnings growth potential, they make financial sense too.

Ireland – huge convenience opportunity

In developed markets, food retail formats are more clearly defined than what we are used to in South Africa, each with its own set of strengths and weaknesses. In BWG, Spar South Africa has acquired multiple banners (brands) which play in various formats. We estimate that 70% of group sales is in the convenience sector (think KwikSpar in South Africa), and BWG is the biggest player in this market in Ireland. We are excited about the very attractive fundamentals of this format:

- The convenience market looks set to take share from other formats, given rising income levels and an evolution in Irish lifestyles. DINK (dual income, no kids) households are on the rise, while elderly people living in cities increasingly demand prepared meals. These developments underpin a more stable demand, enhancing the defensiveness of the format.

- Convenience retailing is hedged against price debasement from discounters, given its different mix of products. Discounters have brought price deflation to fruit and vegetables, as well as to high-value groceries. In contrast, convenience stores specialise in home meal replacement, emergency buys and treat purchases. They also offer very high service levels, while stores are located in busy thoroughfares where discounters are not present.

- Store productivity is high given the heavy footfall through a small space, as well as the high price points of (and high margin on) goods.

In Ireland, distribution facilities are underutilised, which presents an attractive opportunity to drive volume. In South Africa, franchise loyalty sits between 80% and 85%, but this is far lower in Ireland (in the 60s). Franchisees also typically have more power given their size, where big players can run 50 to 200 stores, compared to only five to ten in South Africa. Over the last two years, loyalty has been increasing as Spar has proven its distribution expertise in Ireland, while demonstrating an ability to distribute the whole category basket.

In conjunction with our positive revenue outlook, we think margins have some way to go before reaching their true long-term potential. While margins are around 2% today, these should get above the 2.5% level and tend towards 3%.

Switzerland – a right-sized bet

The acquisition of Spar Switzerland appears to have been a bit rushed on the back of successful purchases in Ireland and the UK. Though management knew they were buying a sub-scale business (which has a market share of only 1% versus the top two players with a combined 80%), it turns out their due diligence intelligence was poor. Profits have fallen since acquisition. Sadly, of the European acquisitions, management paid the highest multiple for this one.

What is reassuring is that Spar has managed the size of its up-front investment accordingly. Spar only acquired 60% of this business versus 80% to 100% of its UK and Irish acquisitions. Furthermore, of Spar's R2.1 billion European investment, only a third was spent on this business.

Although it has disappointed, there are some early signs of a turnaround. Spar has relocated the former head of its KwaZulu-Natal distribution centre to take charge of the Swiss business, with the help of two other South African colleagues. After months of revenue decline, Switzerland has at the time of writing completed six consecutive weeks of sales growth. The Swiss operation represents 8% of group revenue, and while it does not make any money at the moment, just getting it back to a reasonable margin level will be very positive for group earnings, while growing revenues will provide further upside.

CONCLUSION

While Spar South Africa looks different today than it did four years ago, its essence remains the same. Fundamentally it remains an above-average return generator and converter of earnings into cash, with stable margins. Also, its management has a good track record of allocating capital. The business has stumbled in the last year, but much of this is because of the very subdued environment.

Spar is one of those agile businesses that, when faced with adversity, will emerge wiser and stronger. Given its current valuation – it trades on 12.5 times our assessment of normal earnings while offering a 4.5% dividend yield – we like the share more than we did a year ago, and we own a lot more of it as a result. Like the dark knight himself, we expect Spar to rise, and to contribute positively to our portfolios in the process. ■

AIRBUS

HEADING FOR CRUISING ALTITUDE

By Iakovos Mekios

Iakovos is an analyst within Coronation's Global Emerging Markets investment unit. He joined the business in 2013 and is a CFA charterholder.

Few displays of human ingenuity and technological progress are more impressive than the commonplace sight of massive metallic tubes flying people largely safely and reliably into airports across the globe. Aircraft are complex machines that inspire awe in the observer, but when it comes to investing in companies that are involved in either building or operating them, the experience has not always been quite as rousing.

We have always approached investing in air travel with caution. Airbus was a case in point. While it has been on our radar for the last few years, its past as a state-controlled entity with low profitability, a heavy and at times poor investment rate, and governance failures had kept us on the sidelines.

The business was born in the late 1960s and is an amalgamation of various European aerospace and defence companies that were put together over time with the ultimate goal of creating a pan-European champion that would compete with its US counterparts in these strategically important industries. In its commercial aircraft division, the most significant part of its business – which now accounts for 75% of revenue, followed by defence and space with 16% and helicopters with 9% – Airbus reached technological parity with its key American competitor, Boeing, in the early 2000s.

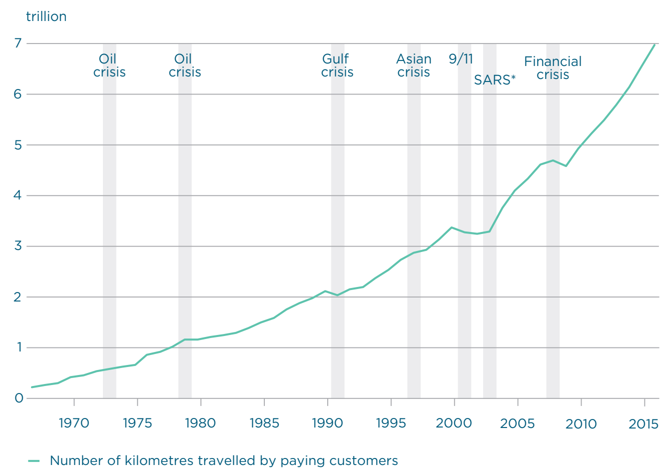
While Airbus (then known as EADS) was listed on the Paris stock exchange in 2000, its full privatisation started in earnest in 2012 when its French, German and Spanish state-owned shareholders agreed to limit their aggregate holding to a maximum 30% of the shares outstanding. By that point, the business was an established duopolist (along with Boeing) in commercial aviation and commanded market share of some 50%.

After decades of outsized investment, it was finally allowed to focus more on commercial priorities. The newly promoted management team at the time signalled this shift in mentality by taking rational decisions relating to its commercial aircraft product cycle: it decided to launch updated versions of its current programmes (known as 're-enginings' due to the application of a new, more capable engine on an aircraft body that was only slightly updated) rather than new, clean-sheet designs. The main advantages of 're-enginings' are that they are quicker to execute, carry lower technological risk – which is mainly borne by the engine makers instead of the aircraft manufacturers – and require significantly lower capital expenditure. Still, due to the long time lag in aviation between product launch and entry into service, the impact of these decisions will only start being evident at the end of this decade and even more so in the 2020s.

SECULAR GROWTH

The most important external variable driving the Airbus commercial aircraft division's long-term revenue growth is, of course, air travel. Ever since aviation became commercialised in the 1950s, air traffic has proven to be very resilient to external shocks. Wars, aviation disasters, natural phenomena, epidemics and economic crises have only temporarily stalled the growth in the number of annual air passengers. Air travel has recovered every time and has correlated well with the growth in countries' GDP per capita (as is evident from the graph on the following page).

WORLD PASSENGER AIR TRAVEL

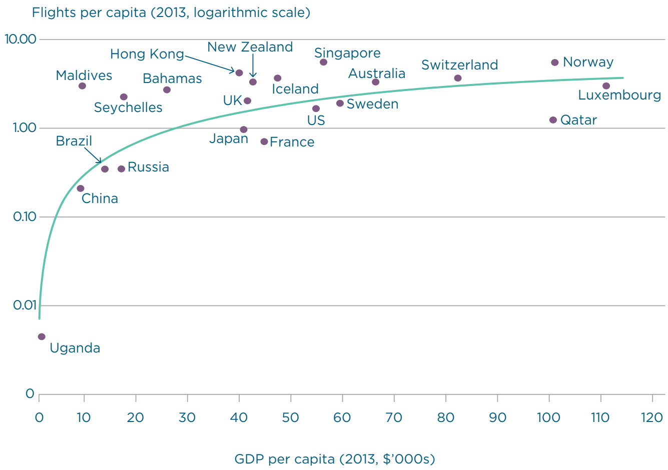


* Severe Acute Respiratory Syndrome

Source: Airbus

This resilience speaks to the strength of the human desire to explore the world and to maintain personal connections. In fact, it seems that the demand for travel is almost insatiable: markets such as Europe and the US have been deemed 'mature' for decades, but keep growing at a reasonable pace as air travel frequency continues to increase.

MORE MONEY, MORE FLIGHTS



Sources: International Air Transport Association, Tourism Economics 'Air Passenger Forecasts'

The best example to illustrate this is the busy North Atlantic air travel market. Unlike other categories where structural growth subsides within a couple of decades, it is hard to imagine an end to air traffic growth in this century.

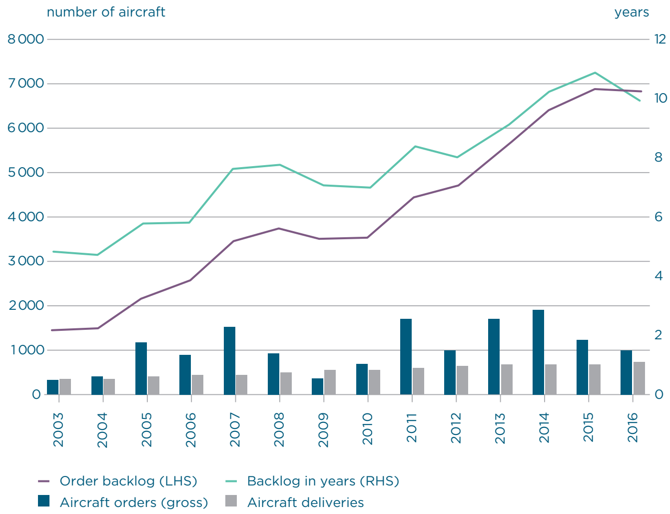
PASSENGER TRAFFIC BETWEEN EUROPE AND THE US

Source: Airbus

BACKLOG AND PROFITABILITY

In order to meet the global demand for aircraft, Airbus has been steadily increasing its production capacity. Backed by a very strong order backlog (worth almost 10 years of production at current production rates), the company is adding to its product suite and upgrading some of its current bestsellers. Still, its current earnings are abnormally low. This is due to the development of three new programmes, the A350, A320neo and A330neo. Airbus uses the cost accounting method to compile its financial statements, unlike Boeing which relies on 'programme accounting'. Airbus incurs the upfront launch costs of a new aircraft programme before the corresponding sales ultimately more than offset these costs over the programme's lifespan of 25 to 30 years. As the A350, A320neo and A330neo programmes mature, they will not only boost the revenue line, but also reverse the dampening effect they have on profitability and strongly improve free cash flow generation.

AIRBUS COMMERCIAL ORDERS AND DELIVERIES



Sources: Airbus, Coronation

On top of this, the company's bottom line is currently affected by currency hedges. Its currency exposure is hedged out for many years in the future, and as a result of the weaker euro, maturing hedges have been expiring in the red. Over time, as hedges unwind, the business should benefit from any US dollar strength: the majority of its revenue is denominated in dollar, while a significant percentage of costs is linked to the euro and the British pound.

RISKS

The A400M military transport aircraft programme has been a problematic remnant from the 'old Airbus' era. The company has had to budget provisions of more than €6 billion in aggregate due to cost overruns and capability shortfalls. The resolution of the aircraft's woes depends on sensitive negotiations between Airbus management and government customers that could take longer than is currently anticipated.

Naturally, the global business cycle will affect aircraft demand (as well as military and helicopter orders), but we believe its large order backlog should insulate Airbus from sharp cyclicality. Moreover, barriers to entry are high:

new aircraft from competing manufacturers – Chinese and Russian in particular – appear at least 10 to 15 years away from becoming credible, commercial alternatives to the duopoly's products.

Although governance has improved materially in the last few years, Airbus faces outstanding investigations on alleged past transgressions. If these were to result in fines, we believe Airbus has the balance sheet to withstand them comfortably. We take governance into account when deciding on the quality of a business and we incorporate our view into the fair value multiple we assign to the company.

VALUATION

The stock trades on 18.5 times its expected 2018 earnings, which may seem like a rich multiple to pay for a European industrial. However, we believe the current price only partially discounts the profitability improvements that Airbus should deliver by the end of the decade, and almost completely ignores a second leg of profit uptick in 2020 to 2025 as new aircraft programmes enter maturity. Accordingly, Airbus recently became a holding in our Global Emerging Markets Equity and Global Equity (developed market) portfolios. The stock is eligible for both international strategies, as Airbus has more than 55% exposure to emerging markets, both by revenue and by its order book. This is the result of the rise of Middle Eastern carriers and the growth of the Asian middle classes, which have shifted global aviation eastward and increasingly towards emerging markets.

Commercial aircraft manufacturers are investments with very long cycles. In our view, this gives long-term investors such as ourselves an edge. We are able to look at a company's earnings and free cash flow generation potential many years out – key to appreciate the value we believe lies in Airbus. ■

This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein are currently 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.

EMERGING MARKETS

FROM 'NICE TO HAVE' TO 'NEED TO HAVE'

By Kirshni Totaram

Kirshni is global head of institutional business. She is a qualified actuary and a former manager of the Coronation Property Equity portfolio. Kirshni joined Coronation in 2000.

Over the years, we have repeatedly made the case for a direct allocation to emerging markets, as they are under-represented in major global indices and under-researched by the world's investors.

Through frequent crises and downswings, we encouraged investors not only to keep the faith, but also to look through the short-term news and focus on the long-term potential. At times, this may have been severely tested as currencies and commodities saw collapsing prices and political shocks wreak havoc on asset prices. We continue to emphasise that there are always investment opportunities present in emerging markets. Emerging market behaviour is far more inefficient than that of developed markets, creating ongoing mispricings from which an active, valuation-driven investor can benefit.

Since the most recent crisis, emerging markets have staged a strong and broad recovery, and the IMF now expects growth of 4.6% this year (and 4.9% in 2018) from these countries. In contrast, advanced economies are expected to expand by only 2.2% in 2017, before slowing down to 2% next year.

The road ahead will be bumpy and one should never expect that emerging market countries will not pose challenges to investors from time to time. Still, despite many daunting challenges, we do believe that the positive trajectory for these countries is growing ever clearer.

In the long run, emerging markets will continue to benefit from structural drivers that are simply not present in developed markets. With younger populations, formalising economies and vastly untapped consumption potential, emerging markets undeniably offer a higher rate of growth potential. An example is China, where only 55% to 60% of the population has access to the internet (compared to an average of 80% in developed markets). Hundreds of millions of consumers still need to be connected, holding massive potential for many consumer and internet companies. Also, while 90% of US households own at least one vehicle, only 6% of households in the Philippines own a car and 2% in Vietnam. In China, less than a fifth of households own their own car. This should provide a strong tailwind for growth in vehicle sales in emerging markets.

Similar structural growth stories are playing out across a number of emerging market industries. A growing consumer class and a strong shift from the informal to the formal sector are benefiting many companies. These include the Russian food retail sector where national retailers continue to profit from the move away from 'mom and pop independents' and open-air markets to branded chains. They also include Indian private sector banks that look to benefit from both a capture in market share from the poorer run state-owned counterparts that still control 70% of the banking sector and the increase in financial services penetration of the relatively underbanked population.

Our valuation approach aims to value these businesses based on what we expect them to earn over the long term. We then look to use any short-term pressure on the share price as a buying opportunity if prices fall significantly below our estimate of intrinsic value. In addition, despite the strong run in emerging markets as a grouping over the past 18 months, we still see many companies that are trading at very attractive upside to their long-term value.

The strong supporting dynamics will drive emerging market growth for many years, and according to some projections, six of the world's seven largest economies could be emerging markets by 2050. By then, Indonesia and Mexico are projected to be larger than Japan, Germany, the UK or France, while Turkey could overtake Italy.

EMERGING MARKETS WILL DOMINATE THE WORLD'S TOP 10 ECONOMIES IN 2050 (GDP AT PURCHASING POWER PARITY)

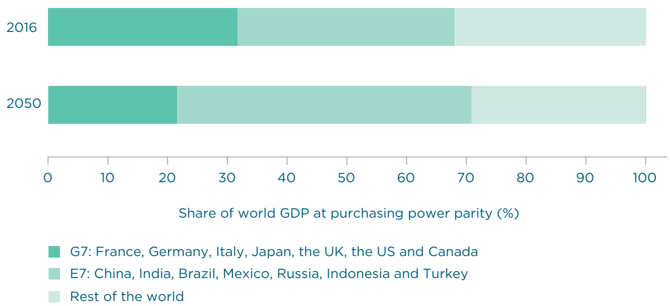
	2016	2050	
China	1	1	China
US	2	2	India
India	3	3	US
Japan	4	4	Indonesia
Germany	5	5	Brazil
Russia	6	6	Russia
Brazil	7	7	Mexico
Indonesia	8	8	Japan
UK	9	9	Germany
France	10	10	UK

E7 economies G7 economies

Source: PricewaterhouseCoopers

Investors without emerging market exposure will fail to benefit from this massive economic shift. For those with a nervous disposition, we believe emerging markets are reaching scale and a level of maturity that bring with it a greater degree of predictability. So while the end of quantitative easing may have a negative impact on emerging markets, our base case is that emerging market economies today are far more robust and we would not expect a repeat of the 'Volcker Shock' when Latin American countries lost a decade of economic growth in reaction to sharp rate hikes in the US during 1979 to 1981. This time round, emerging markets are more resilient, with record-low inflation, flexible currencies and sheer size on their side. Their economies have matured; they are structurally much stronger and able to withstand volatility.

PROJECTED CHANGE IN WORLD GDP



Sources: IMF for 2016 estimate, PricewaterhouseCoopers projections for 2050

So the question shifts from 'why emerging markets' to 'where in emerging markets'. The answer may be more difficult than you think:

A top-down only approach will not necessarily help you. The relationship between economic growth and equity returns has proven to be somewhat tenuous in emerging markets. Notwithstanding the positive economic drivers, we would emphasise that economic growth does not necessarily equal good investment returns, and in our experience, the countries with the rosiest outlooks do not necessarily offer the most attractive long-term investment opportunities.

Our emphasis is on stock selection rather than top-down geographic allocation or macro themes. Our own, unique research will determine what a share is worth (its fair value), and we will only invest if we think the current price is sufficiently below this level, thereby offering a significant margin of safety. This analysis is based on our own detailed modelling of all companies in our coverage list. This includes modelling revenue, cost and margins for at least five years out.

Our proprietary company research is supported by extensive first-hand scrutiny of potential holdings, including country visits and meetings with management, competitors, industry experts and other information sources.

Active management gets you the most benefit. We believe many of the best investments in emerging markets lie beyond the largest indices.

Notwithstanding the strong long-term emerging market investment case, global equity managers remain generally structurally underweight in emerging markets. For example, the MSCI All Country World index, the most important index for global markets, includes a much smaller emerging markets allocation than their share of global GDP would justify. This is because capital market development in these countries is not as evolved as their developed-market counterparts and many large emerging markets businesses have lower free floats than their peers in developed markets. When international investors do invest in emerging markets, it tends to be in a narrow universe of the biggest, most liquid names in the asset class.

Importantly, we do not believe the MSCI Emerging Markets Index is an appropriate reflection of all the value and investment opportunities in emerging markets. Many of the holdings in the index often are below-average businesses (particularly state-owned banks and energy groups), subject to significant state regulation. Often these companies are poor stewards of capital and exposed to cyclical earnings. We do not believe they represent the full opportunity set in emerging markets. And just like any such index or by investing in an index fund, you would systematically own more overpriced stocks, sectors and countries and less of their underpriced counterparts. The importance of researching and selecting a portfolio of the best opportunities within emerging markets is even greater when the overall backdrop is challenging. You want to be confident that the investments in your portfolio are able to weather the storm and, in many cases, come out stronger on the other side. Accordingly, we build entirely clean-slate portfolios based on our assessment of the most compelling risk-adjusted investment opportunities in emerging markets. Our portfolios look very different to the index. In fact, we are comfortable taking decisive positions away from the benchmark when the investment case is compelling, as these positions are underpinned by convictions derived from our proprietary analysis.

We have identified many great businesses in fast-growing industries with small (or no) weightings in the index that have resulted in significant value creation for our clients over the years. This is evident in the performance of the Coronation Global Emerging Markets strategy which has delivered an annualised return of 6.7% (in US dollars, net of fees) since inception in 2008. The strategy has outperformed its benchmark (the MSCI Daily Total Return Net Emerging Markets USD) by 3.6% per annum, net of fees.

Given our expectation that all asset class returns may be lower going forward, exposure to these emerging market higher-growth opportunities, provided the right companies are bought at the right price, will remain vital. ■

The volatility of the MSCI Daily Total Return Net Emerging Markets USD (NDUEEGF Index) represented above may be materially different from that of the Global Emerging Markets Equity Strategy. In addition, the holdings in the accounts comprising the Strategy may differ significantly from the securities or components that comprise the MSCI Daily Total Return Net Emerging Markets USD (NDUEEGF Index). The MSCI Daily Total Return Net Emerging Markets USD (NDUEEGF Index) has not been selected to represent an appropriate benchmark to compare the Global Emerging Markets Equity Strategy's performance, but rather is disclosed to allow for comparison of the Strategy's performance to that of a well-known and widely recognised index.

ZIMBABWE

RETURNS THAT SOUND TOO GOOD TO BE TRUE ...

By Floris Steenkamp

Floris joined Coronation as an investment analyst in the Global Frontiers unit in 2014. Previously, he was an audit manager in the financial services division of PricewaterhouseCoopers.

You may think that the countries with the best-performing stock markets are those whose economies are booming, and those that enjoy large foreign investment inflows and stable political environments. However, when you look at the list of the best-performing stock markets thus far in 2017, you will find that the top spots are occupied by some unlikely candidates. Markets like Argentina and Kazakhstan (both up by more than 40% year to date in US dollar) saw strong recoveries from very low bases, but the real outliers are the two countries right at the top of the list, which are there for completely the wrong reasons.

In Venezuela, the stock market gain of more than 1 000% merely reflects the currency printing and hyperinflation in the economy. The official exchange rate is not the rate at which people unofficially exchange US dollars and the stock market gains therefore largely signify the true currency devaluation.

There are parallels that can be drawn between Venezuela and the second-best performer, Zimbabwe, which is up 189% year to date (to end-September). You would think that the performance in Zimbabwe – which adopted the US dollar as its official currency – should not reflect a currency devaluation, but in reality the country has created a new form of currency printing. As a result a dollar in a bank account in Zimbabwe is no longer worth the same as a physical US dollar elsewhere.

The problem with adopting the US dollar for Zimbabwe, which imports more than it exports, is that the dollars in the economy reduce if there are not enough foreign investments or international funding to plug the gap. After adopting the US dollar in 2009, Zimbabwe experienced a few years of economic growth, with renewed interest from foreign investors. However, in addition to the severe decline in agricultural output which turned the country from a net maize exporter to a net importer over the past three decades, a number of factors more recently resulted in accelerated outflows of US dollars.

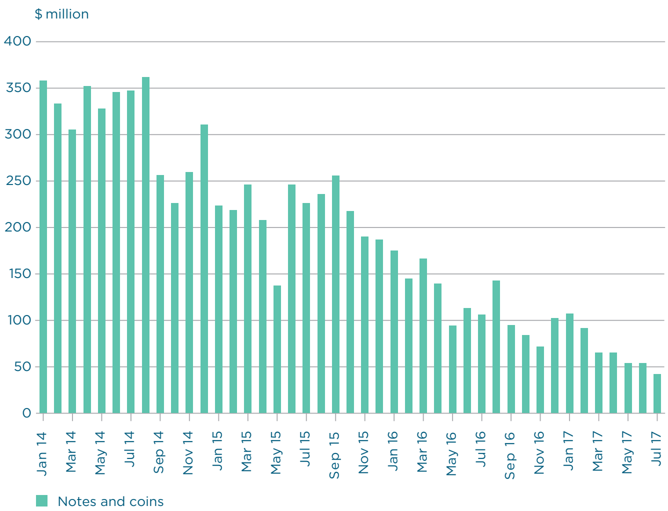
Exports declined as gold, which accounts for almost a third of Zimbabwe's exports, fell from above $1 700 per ounce in 2012 to below $1 100 per ounce in 2015.

As Zimbabwe's largest trading partner, the fact that South Africa's rand lost almost half of its value against the dollar between 2012 and 2016 has left Zimbabwe completely uncompetitive. It became much cheaper to import, hitting local businesses hard. It also meant that the US dollar value of diaspora remittances reduced, dropping by almost 18% in 2016 alone.

Net direct foreign investments slowed from $473 million in 2014 to $255 million in 2016, and portfolio investments also turned negative last year.

It has also become almost impossible for the country to access international funding, as these lenders are demanding significant reforms. This means that the physical US dollars in the economy are now close to being depleted, which is evident from the following graph showing the decline in currency held by the commercial banks.

NOTES AND COINS HELD BY COMMERCIAL BANKS IN ZIMBABWE



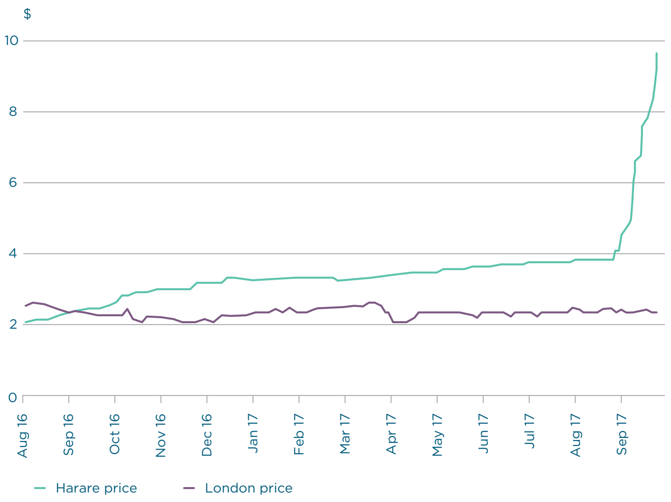
Source: Reserve Bank of Zimbabwe

The cross-border flow of dollars, particularly out of the country, has become more and more regulated, with imports of basic food products and the inputs of net exporters being prioritised, while the capital of investors is (much) lower down on the list. This means that for all practical purposes it has become impossible for a foreign investor to repatriate funds.

In 2016 the cash shortages became so problematic that the Reserve Bank started printing the so-called 'bond notes', basically a new form of local currency that officially holds the same value as the US dollar. However, what started as $10 million in bond notes injected into the market in November 2016 grew to at least $175 million, with talk of much more to come. The combination of the US dollar shortage and the fact that foreign companies do not accept bond notes as payment for imports meant that people were quickly willing to pay more than one bond note for one US dollar. From anecdotal evidence, the premium was between 10% and 25% earlier this year, but this recently increased to around 60%. In many ways this is similar to the black market for US dollars in Venezuela.

Objective evidence that there is a large difference between a physical US dollar and an electronic dollar or bond note in Zimbabwe is the fact that the share price of Old Mutual, which is listed in both Zimbabwe and London, trades at vastly different values on the different exchanges. Many investors track this difference as an estimate of the effective currency devaluation. The following graph shows that Old Mutual's Zimbabwean-listed shares, which traded at parity in August 2016, were almost four times more expensive than the London-listed shares at the end of September 2017. Stated differently, the Old Mutual share price in Zimbabwe needs to be impaired by 73% to reflect the same share price as the London listing.

OLD MUTUAL SHARE PRICE



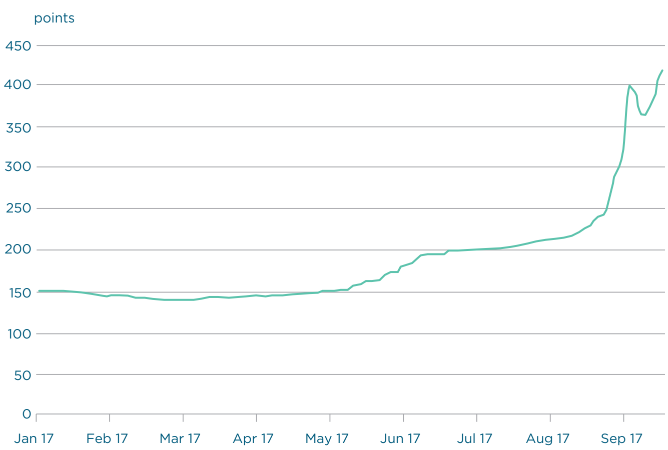
Source: Bloomberg

At ATMs in Zimbabwe, people struggle to draw more than $20 per day, and the money they do get can either be in the form of US dollars or bond notes, with the latter being much more likely. Although locally produced food products are still priced at a level fairly similar to what they were at the beginning of the year, signs of hyperinflation are emerging, with some imported products tripling in price over the last few months.

With the hyperinflationary mid-2000s still fresh in investors' memories, they are doing exactly what they did during that time and are using all cash trapped in Zimbabwe – either in the form of bond notes or electronically such as a bank account balance – to buy assets that store value. Property prices rise as people put their cash into real estate and companies are even reporting a jump in the sales of electronic goods.

But the most conspicuous reaction is the way people have been piling into the stock market. Locally listed Zimbabwean equity prices have seen excessive and unwarranted gains, with share prices now well above our estimates of fair value. Using these quoted prices, our African-focused portfolios showed large paper gains. However, as these gains are not realisable, we had to evaluate our valuation methodology for these companies to ensure that we do not overstate performance, and that both new investors into these strategies and clients who want to withdraw funds are treated fairly. As a result we have impaired a significant portion of the value of all in-country Zimbabwean assets to account for the unwarranted gains.

ZIMBABWE INDUSTRIAL INDEX



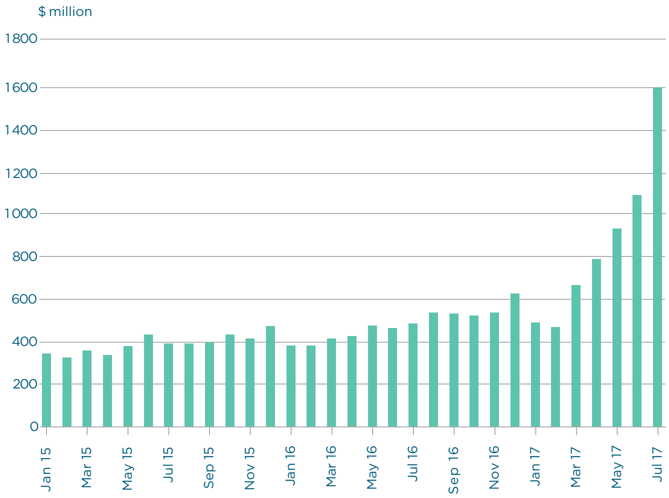
Source: Bloomberg

The Zimbabwean exposure of our African portfolios is largely concentrated in Econet Wireless and Delta Corporation. With returns for the first nine months of this year of 243% and 212% respectively, these two companies still contributed positively to the strategies' overall returns over this period, despite the write-downs.

Although the operating environment in Zimbabwe is currently extremely challenging, these two high-quality businesses are entrenching their moats as the dominant players in their respective industries.

A good example is EcoCash, Econet's mobile money business. With a market share of close to 100%, this business is thriving in the current environment. Zimbabwe's cash shortages resulted in a spectacular rise in the number of transactions on its mobile money platform, as demonstrated by the graph below. This environment is driving a massive acceleration in the adoption of mobile money technology, which has transformed this business. From simply providing an alternative option for payments a few years ago, EcoCash is now an absolutely fundamental part of the economy.

VALUE OF MOBILE TRANSACTIONS IN ZIMBABWE



Source: Reserve Bank of Zimbabwe

Africa has experienced a number of currency crises over the years. We know they do not last forever and we have seen the positive outcomes of being invested in countries like Egypt and Nigeria when their currency situations improved. We do not know when this will happen in Zimbabwe, but what we do know is that at some point something has to give. If shelves are empty and filling stations run dry, the country will be forced into significant interventions, and with its recent traumatic events still fresh in memory, this might well play out much faster this time around. The signs of hyperinflation are already clearly visible and the possibility of a watershed moment is as real as it has ever been, with increased discontent among the general public, more reports of political infighting and government's finances basically depleted.

We still view the Breadbasket of Africa as a country with immense potential and our focus is on owning the high-quality companies that will emerge from this volatile environment as stronger businesses. ■

This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein are currently 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.

GROWTH AND INFLATION

CENTRAL BANKS SHOULD FACE EASIER CHOICES

By Marie Antelme

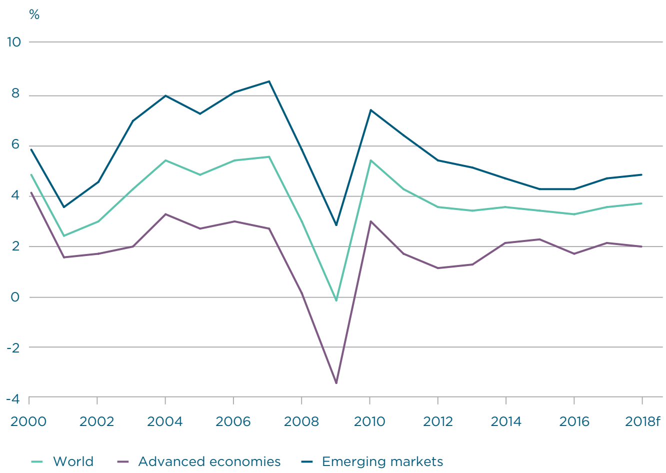
Marie is an economist within the fixed interest investment unit. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

One of the most baffling themes this year has been the divergence of growth and inflation. Since mid-2016 there has been a good and surprisingly broad-based acceleration in GDP growth, but followed by a marked deceleration in accompanying inflation pressure from early 2017. This is particularly evident in key developed economies like the US, Germany and even Japan, where unemployment has reached historically low levels, but wage pressures are largely absent. This dynamic has put central banks in a difficult position – economic activity has recovered well; in fact, in some countries growth is running ahead of potential, but low inflation has limited scope for policy normalisation. In turn, this has created a very positive environment for emerging markets, with good support for commodity prices but low volatility. Accommodative developed market policy settings continued to be very supportive of risk appetite. This seems about to change.

Global growth has been consistently revised higher this year. The latest IMF forecasts expect real output across the world to expand at a rate of 3.6% in 2017 and 3.7% in 2018. In April, the IMF was still expecting 3.5% and 3.6% respectively, and the improvement is distributed fairly equally between developed and emerging economies. There are good signs that growth will persist: in the US, GDP growth is set to be 2.2% in 2017 and 2.3% in 2018. Recent data support ongoing momentum, with unemployment at 4.2% in September and good indications that capital investment is picking up. In Europe, aggregate growth is forecast at 2.1%, from 1.8%, with unemployment at 9.1%, and strong growth expected from Germany in particular, although the whole region should contribute. In Japan, the recovery has been stronger than most expected, and here too momentum has been building. Growth is forecast for 1.5% this year and 0.7% next year. Only the UK, amid ongoing political and Brexit-related uncertainty, has suffered, and growth is expected to slow to 1.5% next year, from 1.7% in 2017.

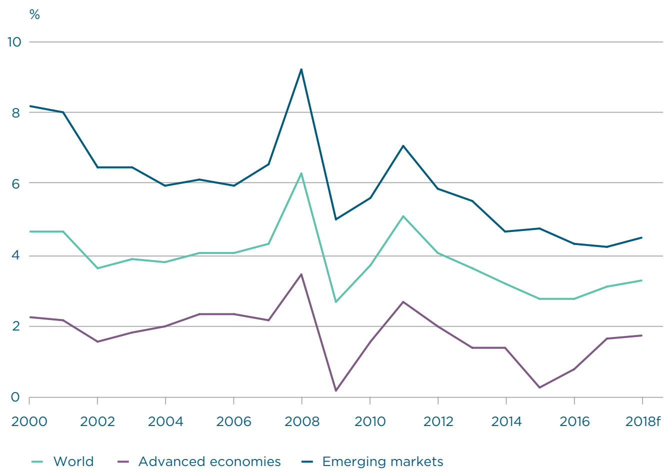
Despite strong growth momentum, global inflation remains low. The IMF forecasts global inflation at 3.1%, with developed economies at 1.7% this year and emerging markets at 4.2%. In the aftermath of the crisis, inflation was low globally because of deficient demand, excess capacity and collapsing commodity prices. Inflation averaged 3.6%

GLOBAL GDP REAL GROWTH



Source: IMF

GLOBAL CPI INFLATION

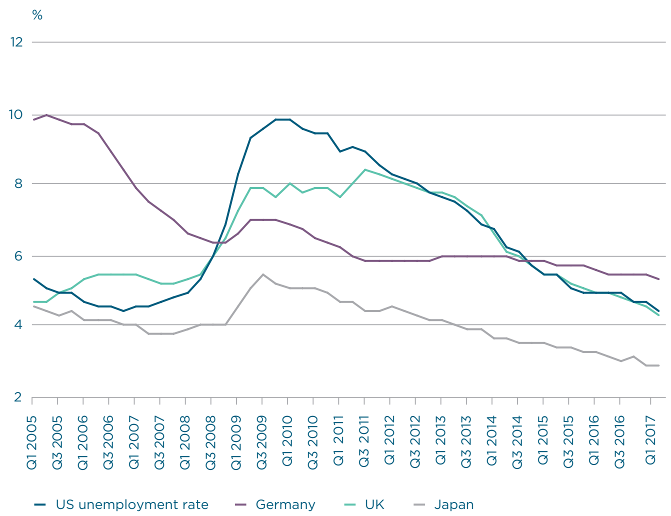


Source: IMF

from 2009 to 2015 (compared to 4.4% in the previous eight years, which included very high post-crisis inflation in key emerging markets). But in developed economies, it was much lower, at 1.2%, prompting more unorthodox monetary policy settings to ensure a deflation cycle did not take hold. From mid-2016, globally both growth and inflation started to accelerate, fuelled by the start of the current growth acceleration, and an associated improvement in commodity prices. But by early 2017, these paths diverged: global inflation was tracking 1.6% by mid-year, with growth 3.4%, throwing monetary policy into a quandary, especially at the Federal Reserve (Fed).

In part, the moderation in inflation was due to lower food and energy prices, and in some cases idiosyncratic factors like US telecommunications and healthcare pricing. But the biggest factor was very low wage growth, despite ongoing tightness in labour markets. Low wages have been a legacy of the financial crisis and the recession which followed. Labour market slack, underemployment, an increase in the number of pension-age workers in the labour force, low inflation expectations, more regulatory flexibility, automation and technological changes may also have contributed. Looking ahead it seems more likely than not that inflation will again accelerate. Cyclically, the disinflationary pressure of low food and fuel inflation has started normalising, and some of the (mostly US) data oddities are unlikely to be repeated. The key signpost is wage acceleration, and there is evidence that labour markets – globally – are becoming tight enough to see higher wages.

UNEMPLOYMENT RATES IN DEVELOPED COUNTRIES



Source: Datastream

Signs of pricing power will certainly make the job of central banks easier. Even without it, most central banks in the developed world – with the notable exception of Japan – have signalled that they are moving closer to more normal policy settings. Policymakers can see their economies at or near full employment, with visibly good growth momentum. External risk has also diminished with the broader global growth recovery.

The Fed is ahead of the pack, having already raised the Fed Funds rate by 75 basis points (bps), and signalled to markets that it intends to start shrinking its balance sheet. The European Central Bank, whose job is a bit harder – not only because Euro area inflation is low but also because the growth recovery is less even and there is a legacy of high government debt and banking sector fragility in some countries – has said that it intends to slowly reduce its active quantitative easing programme from the end of 2017. The Bank of England is also in an uncomfortable position, with high inflation but low growth to contend with. It is expected to raise rates by 25 bps in November, but it is uncertain how much more may be to come. Despite the better-than-expected growth outcomes, the Bank of Japan will most likely wait for very good evidence of an overshoot of its 2% inflation target before throttling back its massive monetary stimulus.

What does this mean for emerging markets? The low inflation world has been a boon for emerging markets, with recovering global trade, higher commodity prices and accommodative monetary policy settings supporting growth while still fuelling demand for their 'yielding' assets. The biggest risk is that inflation in developed economies rises much faster than currently anticipated, forcing a stronger monetary policy response than expected. Higher developed economy yields and rising policy rates would undermine emerging currencies and make financial assets relatively less attractive. For countries like South Africa and Turkey, which are reliant on foreign funding, this would see a (much) weaker currency, higher yields and pressure on the central bank to raise policy rates.

At present however, a moderate rise in developed market inflation to more normal levels will probably be accompanied by a modest slowing in growth, and a slow, well-telegraphed normalisation of monetary policy settings in large developed economies. There will always be risks – of higher (or again lower) inflation, of disruptive central bank balance sheet management, high debt levels, ongoing leverage and geopolitical events. But in a world supported by sustained decent growth, these risks pose less of a threat than at any time in the past almost decade. ■

A DECADE OF DISTORTION

THE GRIM LEGACY OF THE FINANCIAL CRISIS

By Tony Gibson

Tony is a founder member of Coronation and a former CIO. He established Coronation's international business in the mid-1990s, and has managed the Global Equity Fund of Funds strategy since inception.

INVESTOR COMPLACENCY

As we approach the 10th anniversary of the global financial crisis, there is again much to worry about. In one word, complacency is the biggest investment risk at present. Over the past ten years, new risks have appeared – more specifically in the areas of volatility and liquidity. Quantitative easing has created the delusion of permanent liquidity, as well as encouraged the mispricing of risk. Pretty much every asset class is currently making new highs, supported by a range of positive factors. The strongest of these supports is the steadily improving rate of global growth (albeit to levels well below those prevailing in the last decade before the crash), coupled with inflation remaining subdued. Investors have concluded that the combination of these factors will be positive for corporate earnings. Additionally, this is within an environment in which monetary policy remains very accommodative. Although central banks wish to 'normalise' monetary policy, the fear of a policy error is holding them back from implementing the process any faster than 'extremely gradually'. Essentially, investment markets are currently in a positive virtuous circle.

As mentioned, global inflation remains low, despite improving growth. In the US, the country at the top end of developed market inflation, the core inflation index is increasing at an annual rate of only 1.4%. This is well below the Federal Reserve's (Fed) inflation target of 2%. In Europe, the core inflation rate is currently 1.2% – again well below the 2% target set by the European Central Bank (ECB). In Japan, inflation is running at a mere 0.5%. Even in emerging markets, inflation presents no meaningful pressure, with the Bloomberg inflation index for emerging markets currently at 3.4%. The net result is that, despite the intention to normalise monetary policies, central banks continue to expand their balance sheets to support growth in the developed nations. Research suggests that, over the past 12 months, the sum of the ECB, Fed and Bank of Japan balance sheets has grown by 11.4%.

The combination of improving global growth, moderate inflation and supportive central bank policy has therefore provided a positive backdrop for global equity markets this year. And barring a shocking turn of events in North Korea (as discussed on page 11), that same positive combination seems likely to continue to support equity markets in coming months.

Given the prevailing investor complacency, equity valuations need to be monitored carefully. It can be argued that global equity markets trade at reasonable valuations, with price earnings ratios for the MSCI World, MSCI Europe, Australasia and Far East, and MSCI Emerging Markets indices trading at 16.4, 14.5 and 12.6 times forward earnings respectively. Put another way, earnings yields of 6.1%, 6.9% and 7.9% on these equity markets respectively still seem quite competitive relative to prevailing government bond yields. To give this context, for example, the real yield on 10-year inflation-indexed US Treasuries is trading at only 0.3%. Real yields in Europe and Japan actually remain negative.

THE GREAT UNWINDING

This relatively benign interest rate environment for developed market nations should give emerging market central banks latitude to ease monetary policy on a discretionary basis in response to country-specific inflation trends. To illustrate this, in August we saw rate cuts in India, Indonesia and Colombia, while rate cuts are expected soon for Brazil, Hungary and Russia. The weakness of the US dollar this year has also given emerging market central banks more latitude to opt for easier monetary policy where appropriate.

There are of course several sources of economic uncertainty beyond the North Korean issue. The disruptive force of Hurricane Harvey is likely to add volatility to US economic data in coming months – at a time when the country has to grapple with the ongoing potential for a government shutdown. There is also concern that China's negative credit impulse could slow growth in coming months. Still, recent Chinese data have been notably resilient, with the official Purchasing Managers' Index strengthening to a solid 51.7 in August, which is the second-highest reading for the year.

On the current state of complacency, it should be recalled that a decade ago, subprime problems were thought to be contained, global stock markets were scaling record highs, negative interest rates were unimaginable and barely anyone had put the words ‘quantitative’ and ‘easing’ together. However, this state of Nirvana met its demise soon after, and quantitative easing has been a feature of the economic and investing landscape ever since. Therefore, despite the current sanguine approach from investors, the Fed’s announcement that it will begin rolling back quantitative easing should be seen as a defining moment in the post-crisis era. That said, many investors remain dismissive about its implications.

ARTIFICIALLY LOW COST OF CAPITAL

A further point that investors should not overlook is the fact that borrowing costs for companies are at record lows. It must, however, be pointed out that the overall borrowing cost for companies is depressed largely because of historically low government bond yields. Credit spreads – the difference in yield between a treasury bond and a company bond – are still some way from their tightest levels of prior cycles. For instance, credit spreads for US investment-grade companies are currently around 135 basis points (bps). They were actually well below this level in 2007 and in 1997. Meanwhile, European investment-grade spreads now trade at about double their 2007 level of near 60 bps. The conclusion of this is to remind investors that the corporate sector is not necessarily mispricing risk; it is the whole interest rate curve that is distorted by ongoing central bank interference.

In addition to the distortions caused by the prevailing (artificially low) cost of capital, there is a broader societal theme that worries us. Ageing populations, global sourcing of goods and services, and technical innovations are widening gaps in income, job opportunities, living standards and ideology. Secular headwinds continue to disrupt the lifestyles of many people around the world. The symptom of this is the loss of middle-class jobs, wages and benefits, and therefore prospects for a more secure and prosperous future. It is this erosion of the middle class that has triggered a backlash against the status quo – be that against global trade, capitalism, the financial sector or political leaders.

HIGHER TAXES, FEWER SERVICES

Unfortunately, the dearth of well-paying jobs, resulting wage stagnation and the loss of faith in the future will intensify over the next decade as technology increasingly eliminates or automates tasks – including in the labour-intensive service sector. The real worry is that while job anxiety, frustration and loss of confidence are likely to increase populist pressures to protect jobs, incomes and living standards, governments will have limited ability to respond. This is due to the fact that a growing share of public sector revenue will be absorbed by the pension and healthcare needs of ageing populations and an inevitable rise in debt service costs.

Of course, this gradual unwinding of the social order has been partially masked over the past decade by distortions set in motion by well-intended central bank monetary manipulation. Implemented as an emergency measure to prevent the deep 2008 to 2009 recession from spiralling into a self-feeding deflationary contraction, central bank bond buying has caused, in addition to investor complacency, public sector complacency that fed excessive spending and overregulation. Inevitably, over the next decade, a widening gap between public sector income and spending will lead to higher taxes – for fewer services.

If the distortion of borrowing costs had been short-lived, for say, two to three years, the impact of ‘normalising’ interest rates (and central bank balance sheets) would have been limited in scope and duration. Instead, the protracted suppression of interest rates has had an excessive impact on public spending, borrowing and debt service costs.

Since the Fed became a major buyer of new debt issued by the US Treasury, spending has been unconstrained over the past 10 years and US federal debt has doubled, from $10 trillion to $20 trillion. Fed intervention not only reduced the cost of new deficit spending, it also significantly lowered the cost of rolling over maturing debt. Hence, while the total debt doubled over the past decade, the annual cost of servicing the US federal debt has stayed nearly flat.

AN UNSUSTAINABLE ‘NEW NORMAL’

In our opinion, this situation is ultimately unsustainable. As the Fed (soon to be followed slowly by the Bank of England and the ECB) steadily reduces bond buying, a slow but steady normalisation of interest rates will begin. In 2007, the US paid an average of 5% on its $9 trillion federal debt. This year, the US is paying only 2.28% on its $20 trillion debt. A doubling of the debt is masked by cutting the interest rate in half. As interest rates slowly normalise over the next five to seven years, so too will the cost of servicing a further relentless rise in the total US federal debt. If, for example, the average interest rate paid on debt rises to 2.4% next year, 3% in 2020, and 4% by 2024, the annual cost of servicing the US debt will double. Simply put, during the next presidential term (from 2021 to 2024) the president and Congress must spend an additional $80 billion to $100 billion each year – not on schools, healthcare, defence or Social Security, but to pay the rising cost of servicing the federal debt. The majority of Americans do not yet seem to appreciate the gravity of the debt service problem set to explode in the next decade.

There are of course those commentators who believe that we are today in a ‘new normal’ – and that there is an implicit guarantee that interest rates will remain extremely low for many years to come. In our opinion, it will be unwise to indefinitely suspend sound economic thinking. Investment trends do always revert to normal with time. The current level of developed market interest rates is abnormal – and will not endure in perpetuity.

As long-term investors we just do not know how the current set of uncertainties will play out. Investors must therefore give thought to how to navigate the challenges that lie ahead. Not least of these challenges is the fact that most (known) asset classes are highly priced due to excess liquidity and investor complacency. Setting risk tolerance guidelines is one of the steps when it comes to exposure to risk investments. Within risk investments, finding underpriced investments is rare. The focus is therefore more than ever on identifying stocks that can produce real earnings growth on a sustainable basis. ■

CORONATION GLOBAL EMERGING MARKETS EQUITY

INCEPTION DATE

14 July 2008

PORTFOLIO MANAGERS

Gavin Joubert and Suhail Suleman. Gavin is head of Coronation's Global Emerging Markets investment unit with 20 years' investment experience. Suhail is a portfolio manager within the investment unit with 15 years' investment experience.

OVERVIEW

Coronation Global Emerging Markets Equity is an actively managed equity strategy that invests in what we consider to be the best investment opportunities in emerging markets. It aims to deliver long-term capital growth through a focused equity portfolio of securities that we believe offers the most compelling risk-adjusted returns. Our long-term objective is to outperform the MSCI Emerging Markets Index by 3% to 4% per annum over five years and more.

We leverage off our 24 years' experience of managing money in an emerging market like South Africa, which we believe has been crucial in framing our thinking about managing emerging market portfolios. It has provided a key competitive edge relative to global peers.

PORTFOLIO CONSTRUCTION

We are long-term, valuation-based investors. The fair value of a company represents a crucial anchor for our portfolio actions. This strict valuation discipline is exactly the same approach we have used successfully in South Africa for almost a quarter of a century.

Research

We conduct our own research to determine what a share is worth, and only invest if it trades at a sufficient margin below this level. Our estimate of the fair value of a share is based on our own detailed modelling, including of a company's normalised revenue, cost and margins for at least five years out. Setting our own assumptions allows us to avoid anchoring off 'consensus expectations' and sell-side recommendations.

Our proprietary company research is supported by extensive first-hand scrutiny of potential holdings, including country visits and meetings with management, competitors, industry experts and other information sources. Our coverage list comprises around 200 shares that we have filtered down from the broader number of companies listed on emerging market exchanges.As long-term investors, environmental, social and governance criteria are fully integrated into any investment case to understand the long-term sustainability of a business.

Putting the portfolio together

In constructing our portfolios, we pay no attention to the emerging market indices. Our portfolios are constructed

TOP 10 HOLDINGS

Holding	% strategy
Naspers Limited	7.6%
Kroton Educacional SA	5.0%
JD.com Inc ADR	4.7%
Magnit OJSC-SPON	3.9%
58.com Inc ADR	3.7%
Heineken NV	3.5%
Porsche Automobil HLDG-PR	3.4%
Baidu Inc ADR	3.4%
AIA Group Ltd	3.2%
Sberbank of Russia	3.1%

Source: Coronation

GEOGRAPHIC EXPOSURE

Country	% strategy
China	16.9%
South Africa	14.1%
Brazil	13.3%
India	10.8%
Russian Federation	10.0%
US	7.5%
Netherlands	5.8%
Germany	3.4%
Hong Kong	3.2%
France	3.0%

Source: Coronation

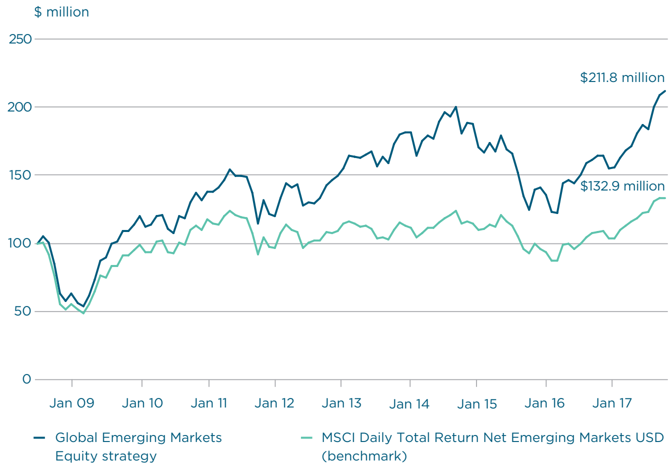
on a completely clean slate and bottom-up basis based on the stocks we believe offer the best risk-adjusted value. Our portfolios are fairly concentrated (50 to 60 stocks) and reflect our high-conviction ideas prominently, but we are not buy and hold investors. If a share reaches fair value in a short period and we believe that the fair value remains correct, we will sell the share. Our portfolios will often have stocks that do not feature in many other funds around the world. Risk is controlled by only owning stocks that trade well below fair value, and our portfolios are constructed with no excessive exposure to any one country, industry or other single identifiable factor that could have an unexpected and outsized impact on portfolio returns.

Some of our key current holdings are stocks that are exposed to the Chinese e-commerce and internet sector, Brazilian tertiary education and Russian food retail.

COMPELLING TRACK RECORD

The Coronation Global Emerging Markets Equity strategy has delivered an annualised return of 6.7% (in US dollar, net of fees) since inception in 2008. The strategy has outperformed its benchmark (MSCI Daily Total Return Net Emerging Markets USD) by 3.6% per annum, net of fees. ■

GROWTH OF $100 MILLION INVESTMENT



The above graph is provided for illustrative purposes only. It reflects composite peformance of the strategy and is gross of fees.

Source: Coronation

The volatility of the MSCI Daily Total Return Net Emerging Markets USD (NDUEEGF Index) represented above may be materially different from that of the Global Emerging Markets Equity Strategy. In addition, the holdings in the accounts comprising the Strategy may differ significantly from the securities or components that comprise the MSCI Daily Total Return Net Emerging Markets USD (NDUEEGF Index). The MSCI Daily Total Return Net Emerging Markets USD (NDUEEGF Index) has not been selected to represent an appropriate benchmark to compare the Global Emerging Markets Equity Strategy's performance, but rather is disclosed to allow for comparison of the Strategy's performance to that of a well-known and widely recognised index.

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