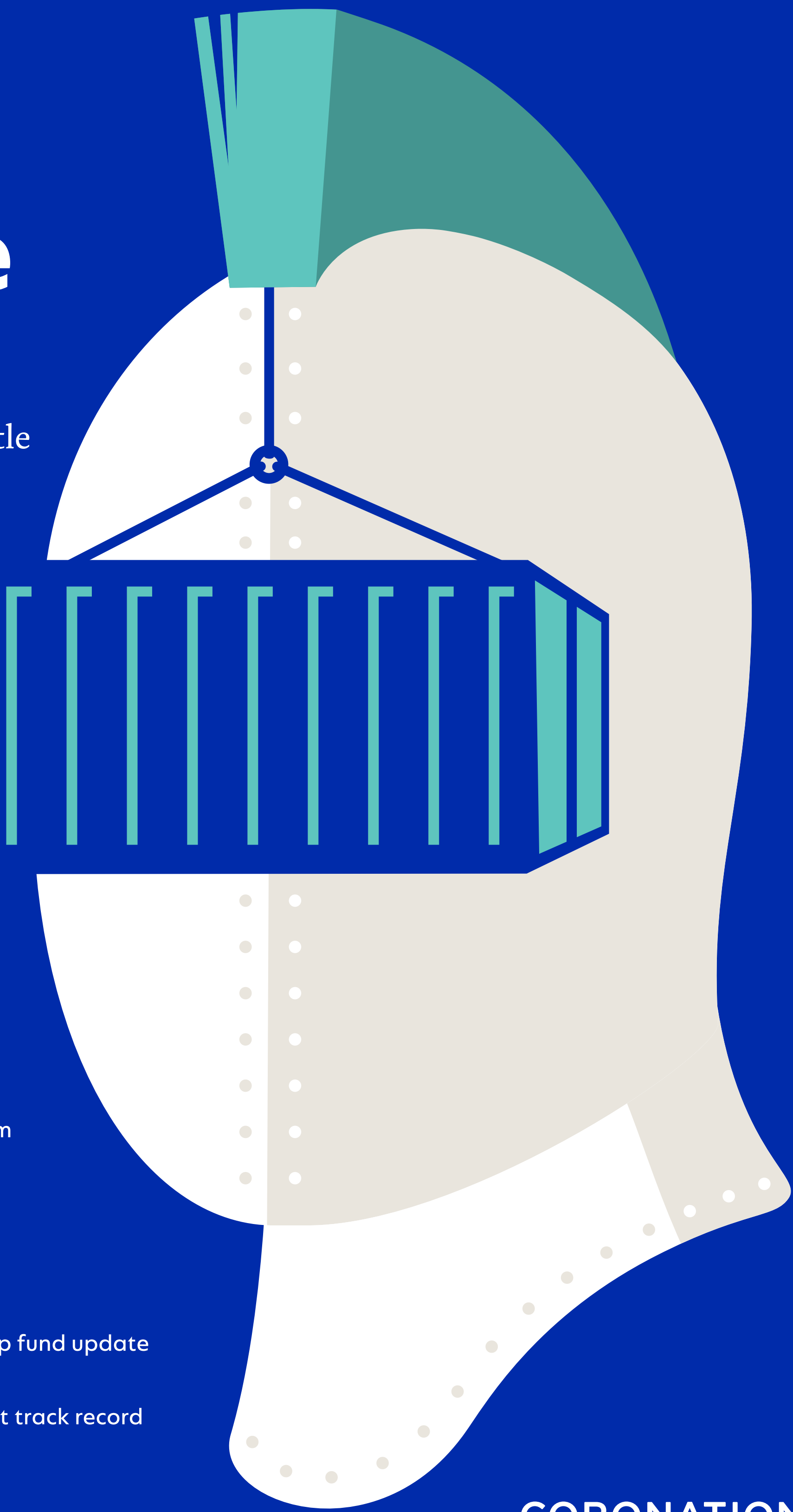
corospondent

The Personal Investments Quarterly

Trade wars

Gearing up for battle



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CORONATION

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Notes from my inbox

By Pieter Koekemoer

"I have walked that long road to freedom. I have tried not to falter; I have made missteps along the way. But I have discovered the secret that after climbing a great hill, one only finds that there are many more hills to climb. I have taken a moment here to rest, to steal a view of the glorious vista that surrounds me, to look back on the distance I have come. But I can only rest for a moment, for with freedom comes responsibilities, and I dare not linger, for my long walk is not ended." – Nelson Rolihlahla Mandela

AS WE CELEBRATE Nelson Mandela's centenary, his legacy of principled but inclusive perseverance in the quest to achieve a fair and free society should resonate with all South Africans. It is easy to become despondent when expectations are not met, especially in this 'post-truth' era where the flow of information is often dominated by demagogues and charlatans attempting to manipulate the narrative for their own benefit. While we should always be realistic about the many challenges still to overcome, we are more likely to make progress if all those with a contribution to make remain committed to enhancing the common ground that is so necessary as a foundation for a society with forward momentum. It is only if we can get most of our people to believe that economic growth will benefit them too that government will feel confident enough to adopt the policies supporting individual freedom which are required to grow the wealth of our nation. While we recognise

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Pieter is head of the personal investments business. His key responsibility is to ensure exceptional client service through a combination of appropriate product, relevant market information and good client outcomes.

that the structural reforms needed to kick-start growth will be tough to implement, we remain cautiously optimistic that enough goodwill remains to be able to travel a little further down the road.

MARKET MOVEMENTS

	2nd quarter 2018	Year to date 2018
All Share Index R	4.54%	(1.70%)
All Share Index $	(9.99%)	(11.41%)
All Bond R	(3.78%)	3.97%
All Bond $	(17.16%)	(6.30%)
Cash R	1.76%	3.59%
Resources Index R	19.63%	15.04%
Financial Index R	(6.02%)	(9.36%)
Industrial Index R	3.96%	(4.35%)
MSCI World $	1.73%	0.43%
MSCI ACWI $	0.53%	(0.43%)
MSCI EM $	(7.96%)	(6.66%)
S&P 500	3.43%	2.65%
Nasdaq $	7.27%	10.65%
MSCI Pacific $	(1.32%)	(1.88%)
Dow Jones EURO Stoxx 50 $	(2.28%)	(3.72%)

Sources: Bloomberg, IRESS

QUARTER IN REVIEW

The second quarter saw a sea change in sentiment. The first-quarter domestic rally rapidly reversed as emerging markets everywhere came under pressure. The rand lost 14% of its value relative to the dollar, resulting in the JSE declining by 12% in dollar terms so far this year. Some perspective is provided by even more extreme moves elsewhere. The dollar gained against all major currencies and South African shares performed better than Chinese and Brazilian markets, while the real pain was felt in Turkey (-31%) and Argentina (-44%). A relatively strong US economy, higher US bond yields, an expectation of further policy rate hikes in the US and Europe, and the Trump government's trade wars combined to generate enough bad news to spook investors. Our economist Marie Antelme and our guest writer Barry Eichengreen provide some insight into why global investors have become more concerned.

Sentiment towards South Africa deteriorated after first-quarter growth surprised on the downside, and as investors became increasingly unsettled by ongoing policy uncertainty, especially in the areas of land reform and property rights, government's intended reform of healthcare funding and the ongoing woes at any number of undercapitalised and productivity-challenged state-owned companies (especially Eskom). One small silver lining was the acceptance of "once empowered, always empowered" in the new mining charter draft, reducing the risk of ongoing dilution of ownership for equity holders in existing mines. Unfortunately, requirements for new mining rights as well as for the renewal of existing mining rights are relatively onerous and will increase investment hurdles for new projects. All these factors have the potential to dampen economic growth. However, investors need to remind themselves that we are in an election year – while louder rhetoric is guaranteed, it is likely that the desire to do much more than kick the can down the road is limited.

Taken together, the above caused local bond yields to surge as foreigners offloaded R65 billion of government bonds over the quarter, similar to the levels of outflows during 2013's 'taper tantrum' and 2015's Nenegate. While many challenges remain, the size of the reaction means that our government bonds now trade at more attractive levels, as explained by Nishan Maharaj (page 24). We have used the opportunity to increase bond exposure from a very underweight position.

We also sold out of Steinhoff across our fund range. In the detailed review of events at the company published in January, we indicated that we do not think it would be in clients' best interests to act while in an information vacuum. It has subsequently become clear, with the recent company disclosures, that the extent of the overstatement of historical profitability is closer to our worst-case scenario at the time. This has led to continued write downs of various Steinhoff assets, and our view is that there is now a high probability of there being no equity value once Steinhoff repays its creditors and settles legal claims. We will take legal action on behalf of clients against Steinhoff, and to the extent legally possible against any other parties that were complicit in wrongdoing. We will continue to provide progress updates as events unfold.

Most of our funds had a reasonable quarter, with our flagship multi-asset funds all returning around 4%. Rand weakness boosted the returns produced by our global funds, with Global Opportunities Equity returning 19% over the quarter. You can read more about your fund's performance in the summary on page 31, or via the fact sheets and portfolio manager commentaries available on www.coronation.com.

As always, valuation remains our beacon in turbulent times and we have used the volatile price environment to build positions in some attractively priced shares.

INVESTOR UPDATE

To make it easier for new investors to start their journey of building a balance sheet, we are experimenting with a new investment channel with no minimum investment amount and an application form that can be completed in a couple of minutes from your phone. To celebrate savings month and our 25th birthday, we are also offering a top-up of up to R250 to all new account holders investing during July. Have a look at www.becauseitsyourmoney.com.

We have recently extended the range of funds that are eligible as holdings in tax-free investments, both directly from Coronation and via all the major fund platforms. The new funds now available are Global Opportunities Equity, Balanced Plus, Capital Plus and Balanced Defensive.

Enjoy the read and please do let us know if there is any area where you think we can do better.

Pieter

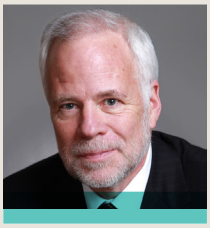
GUEST COLUMN

Trade wars and the last economy standing

But looks might be deceiving

By Barry Eichengreen

Barry Eichengreen is a professor of economics and professor of political science at the University of California, Berkeley, US, where he has taught since 1987. He is an internationally renowned economist who has written widely on the international economy and monetary systems. He is a former senior policy advisor at the IMF.



CURRENTLY THE US economy is firing on all cylinders, while Europe and emerging markets are struggling. Does this mean that president Trump is right – that trade wars are 'easy to win'?

Superficial evidence points in this direction. The Purchasing Managers' Index, the best real-time measure of US economic activity, indicates that no less than 60% of managers saw conditions as continuing to improve in June. New orders, even export orders, expanded even faster than in previous months. The Atlanta Federal Reserve Bank's 'nowcasting' model shows US GDP increasing at a robust 3.8% rate in the second quarter.

In contrast, growth in the five large European economies (Germany, France, Italy, Spain and the UK) dropped in the second quarter. In emerging markets, meanwhile, financial difficulties are mounting. China's stock market and currency have lost ground with the ratcheting up of trade tensions. Other emerging markets have experienced capital outflows, forcing their central banks to tighten. >

Rather than being destabilised by the White House's trade threats, the US economy appears to be thriving, while the economies Trump is attacking are buckling under the pressure.

But the evidence for the US is deceiving. The increase in manufacturing output and orders, including export orders, is a direct consequence of worries about trade policy actions. US companies are accelerating production to get more done before their supply chains and access to imported inputs are disrupted. European retailers are anxious to stock their warehouses with American goods before their governments slap retaliatory tariffs on US exports. This frontloading of production and sales bodes ill for the future. Demand and activity are being created today at the expense of demand and activity tomorrow.

One might ask why producers in Europe and emerging markets are not reacting similarly. The answer is that, in fact, many of them are doing just that. They have the same incentive to stock up on inputs and bring production forward before their trade relations are disrupted further. This explains why there is no discernible deceleration of economic activity in China, at least yet, despite the weakness of both consumption and fixed-asset investment. It explains why growth in emerging markets has not softened significantly despite the turmoil caused by higher US Federal Reserve (Fed) policy rates. It explains how growth in the big European economies still hovers in the 1.5% to 2% range despite the uncertainties surrounding the German diesel emissions scandal, the intentions of the new Italian government and Brexit. Producers there too are stealing from Peter in order to pay Paul. In other words, these observations also bode ill for the future.

Economists may regard a trade war as hard to win, but for Trump, it remains a political winner.

The longer-run implications for the US economy are especially dire because Trump's tariffs target mainly intermediate inputs, not final goods, and handicap sectors disproportionately dependent on global supply chains. Steel and aluminium, the targets of Trump's 'national security tariffs', are inputs into production, so taxes on them make the final goods they go into more expensive. For every steel and aluminium industry job created, multiple jobs in downstream industries are lost. Whereas the US steel industry employs 145 000 workers, steel-using industries employ two million.

The same is true of the Section 301 tariffs imposed in response to China's intellectual property rights abuses – 52% of these tariffs target intermediate goods and another 43% tax imports of capital goods, which are themselves inputs into production. From an economic standpoint, this is known as shooting oneself in the foot.

The same is true of Trump's proposed tariffs on motor vehicles and parts. US automakers import a large fraction, even the majority, of the parts and components used in their assembly operations. No wonder then that Toyota, which builds Camrys at its plant in Kentucky, estimates that Trump's tariffs on automotive parts will raise the cost of its sedan by $1 800. And no wonder that the American Automotive Policy Council, representing the Big Three Detroit-based automakers, opposes the president's trade restrictions.

China, the EU and Canada are largely avoiding this pitfall. The EU's retaliatory tariffs target Kentucky bourbon and Florida orange juice, which are inputs into consumers' digestive systems, not into industrial production. China is targeting US soybeans, and Canada US maple syrup, ketchup and strawberry jam. These tariffs will impact the cost of living – imports from the US will become more expensive – but they will not disrupt manufacturing production. These countries have not been entirely able to resist the temptation to protect and subsidise their own steel industries. But, on balance, they are proceeding in a more sensible manner.

Will the Trump administration change course as evidence mounts of negative effects on the US economy? Would a negative reaction by the Standard & Poor's (S&P) 500, in which US multinational companies are disproportionately represented, rein in the president's worst instincts? Would Trump think twice following evidence that other countries in fact are prepared to retaliate, contrary to confident assertions by the president's trade advisor Peter Navarro? The answer, unfortunately, is no. Trump and his advisors understand neither global supply chains nor the distinction between intermediate and final goods. They do not understand that by cutting taxes and thereby pushing up the dollar, they themselves are causing the US trade deficit that the president finds so objectionable.

So if the stock market reacts badly, Trump will ascribe this not to his own policies but to foreigners, stock market manipulators and the Fed. Trump has already warned other governments of further US action if they retaliate. Breaking with precedent, his economic advisor Larry Kudlow has intervened in the Fed's affairs, urging it to proceed "very slowly" with interest rate increases. Trump's commerce secretary Wilbur Ross has already criticised "antisocial speculators" for driving up steel prices.

The other reason for doubting a change of policy direction, aside from the fundamental ignorance of those at the top, is that Trump's dog-whistle politics appeal to his political base. Trump's bedrock supporters, like the president himself, see international trade as a zero-sum game. They see the mythical flood of merchandise imports, just like the mythical flood of Latin American immigrants (mythical because immigration from Latin America to the US is down, not up), as a fundamental threat to the country, and they are happy to see their president wall them off. Trump is simply delivering on the campaign promises that got him elected, and he is unlikely to turn back, however damaging the consequences. Economists may regard a trade war as hard to win, but for Trump, it remains a political winner.

So what should other countries do? They should carefully calibrate their response to avoid unnecessarily provoking an all-too-easily-provoked US president. They should target exports of bourbon and cranberries from the home states of the US Senate majority leader and House of Representatives speaker in an effort to drive a wedge between the president and Congress, in the hope that the latter might show some backbone and restrain an irresponsible executive.

Above all, other countries should avoid resorting to a further cascade of tariffs. If the US taxes Chinese products, China will divert those exports to other markets, intensifying import competition there and creating a temptation to ratchet up barriers against Chinese goods. The trade war could then go global and spiral out of control. A modicum of export restraint by China would help to limit this danger. That the Chinese authorities have begun intervening in the foreign exchange market to prevent their currency from weakening further and artificially goosing exports is a good sign from this point of view.

If there is a silver lining for South Africa, it is that the country depends less on global supply chains than many other emerging markets. Moreover, if the US economy weakens, the Fed will moderate its pace of tightening, which will help with South Africa's dollar funding costs. This may be scant recompense. But it is at least something. ✚

South African impact

By Marie Antelme

South Africa is a small, open economy with global growth, trade and overall financial conditions having a meaningful impact on domestic economics. Initial estimates of the direct impact on global GDP of the first round of tariff increases imposed by the US on China were low, at 0.1 to 0.2 percentage points for 2018, with a slightly higher impact in 2019. This would have had a negligible impact on South Africa's GDP growth, off the current low base.

However, the newly announced escalation in planned tariff increases are likely to have a more meaningful effect on global growth into 2019 than initial estimates suggest, and the imposition of a global tariff on vehicle imports to the US would more directly impact domestic trade. South Africa exports both vehicles and parts to the US, and imports a proportion of both too.

On a net basis, total trade in vehicles between South Africa and the US is about 1.9% of GDP.

More importantly, the indirect effect of an escalation in trade conflict may be much bigger, but is harder to measure. With the expansion of tariffs, the risk of a greater disruption to globally integrated supply chains has increased, and prices are likely to rise. Greater uncertainty would also influence confidence and investment, and may result in tighter financial conditions. The broader impact of a cyclical slowing in global growth on commodity prices and a drop in investor sentiment would see domestic terms of trade deteriorate and the currency weaken, leading to higher inflation and possibly prompting an increase in interest rates.

Where did my return go?

Following through when the right actions seem wrong

By Christo Lineveldt

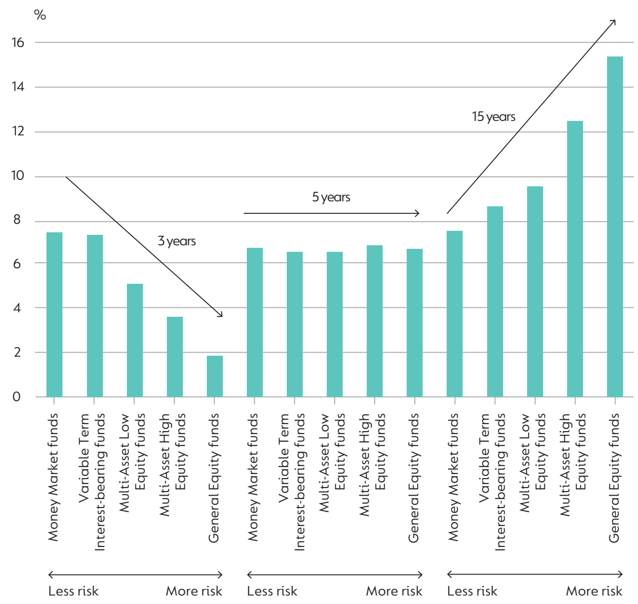
GROWTH ASSETS DISAPPOINTED in the recent past. It is understandable that some investors may want to give up. But only looking backwards may lead you to the wrong conclusions.

RECENT OUTCOMES WERE WEAK

Recent experience has planted doubt in the minds of some investors as the risk-return trade-off did not hold. The truth is that over the five years to the end of May, you achieved no additional return when increasing risk incrementally. The graph overleaf illustrates this point, using some of the key unit trust categories along the risk spectrum. Regardless of whether you invested in a low-risk money market fund, a fully invested equity fund or anything in between, your average return outcome would have been similar. The issue is amplified when you assess returns over three years. Over this period, investors were better off in money market funds than in equity funds – you experienced the risk, but not the return. This inevitably leads some investors to ask certain questions: is it still worth exposing my portflio to risks associated with growth assets? Should I rather derisk my portfolio? Or put simply: where did my return go?

Christo is an investment specialist within the Coronation Personal Investments business, responsible for the distribution of Coronation's funds across IFA and corporate channels. He holds a BCom in Economics and Econometrics, a Postgraduate Diploma in Financial Planning, and is a Certified Financial Planner.

GROWTH ASSETS' RISK-RETURN RATIO OUT OF KILTER



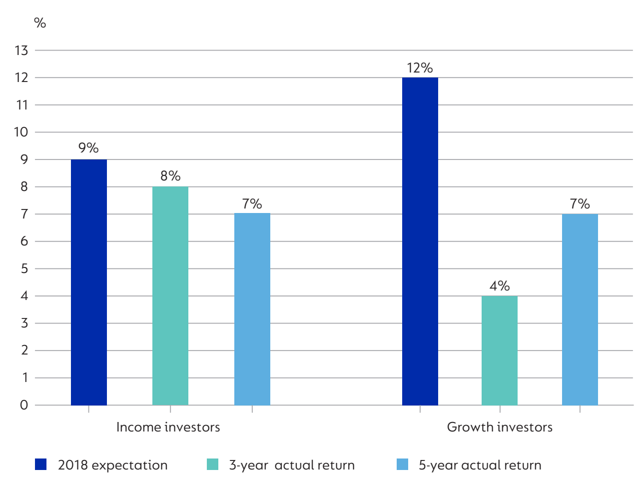
Source: Association for Savings and Investment South Africa (ASISA)

INSIGHTS FROM OUR INVESTOR SURVEY

We recently concluded our second annual client survey in which we used the opportunity to ask investors a range of questions that could help us create better outcomes for clients. One of the areas that we focus on is the expectations gap: the difference between investors' expected returns and their actual experienced returns. The results can be interpreted as a barometer for how comfortable investors are about their investment choices.

The graph below shows the gap in practice. On average, those investing for short-term income expect an annualised return of 9%, compared to the actual outcome of 8% and 7% per annum

EXPECTED VS ACTUAL RETURNS



Source: Coronation

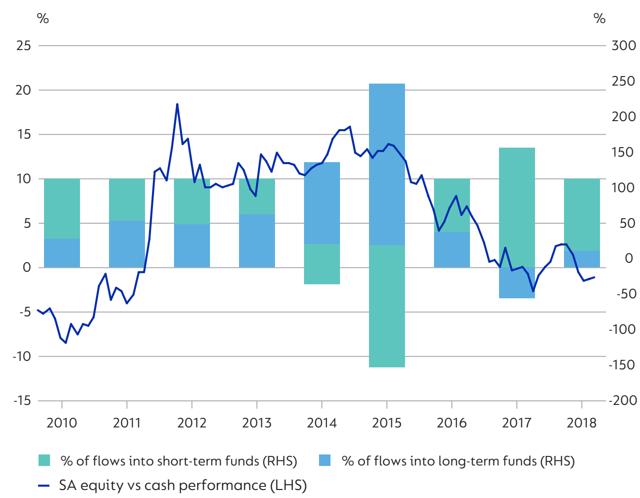
over three and five years, respectively, of the average flexible fixed interest fund. In contrast, those investing for growth over the long term have endured a much more disappointing experience over the last few years. Our survey shows that the average long-term investor expects 12% per annum. Compare that to the average return of your typical balanced fund of only 4% and 7% per annum over three and five years, respectively. Although one can argue that investor expectations are too optimistic and require moderation to be prudent (at the current 4.4% CPI rate, it implies a 7.6% per annum real return expectation, compared to a 5% real return as the generally accepted reasonable expectation for a balanced fund), the reality is that the average balanced fund has only delivered a third of the expected return over the last three years.

Unfortunately, this expectation gap may be interpreted as justification for taking actions that could prove to be wealth destructive over time.

WEALTH DESTRUCTION IN ACTION

The need to act when expectations are not met is an understandable human response, but could result in several unintended consequences when ill conceived. Selling growth assets after periods of poor performance, or buying more growth assets after periods of exceptional performance is often to the detriment of growth investors over the long term. Our analysis of flow trends in the unit trust industry indicate that many investors are derisking their portfolios – consider the graph below.

INVESTORS DERISKING THEIR PORTFOLIOS



Source: Coronation

Leading up to 2015, investors displayed an increasing preference for long-term funds. As the graph shows, it also coincided with a period where the three-year return gap between equities and cash was compelling. In short, investors increased their exposure to equities after equities had significantly outperformed cash. Over the last three years, we have seen a reversal away from a strong preference for long-term funds to investors appearing to de-risk into short-term funds. This move has again happened at a time when equities had already underperformed cash.

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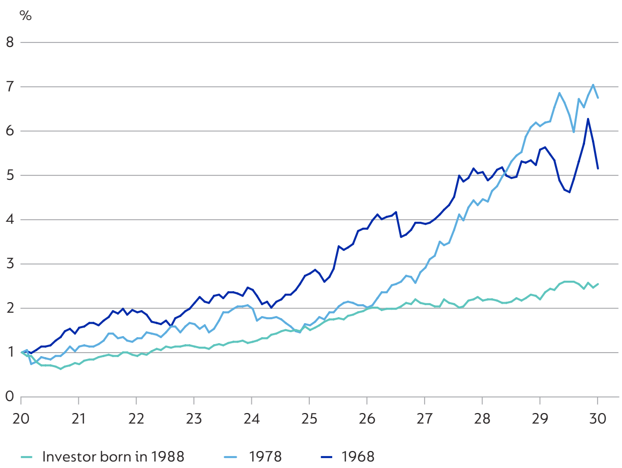
MANY PATHS ARE POSSIBLE, BUT ONLY ONE ROAD IS TRAVELLED

Humans need organising narratives to cope with the complexities of life. We just do not have the bandwidth to engage in-depth with every issue that crosses our path. Often, our own experience plays an outsized role in the stories we use to shape our view of the world. This is especially true for subject matter we do not engage with regularly.

Take the difference in experience between three investors in the graph below. It shows the investment returns achieved during their 20s for investors turning 30, 40 and 50, respectively, this year. We use 10 years as an evaluation period, as a decade is the minimum timeframe that can be described as long term. When the two older investors became adults in the 1990s and 2000s, the local share market produced above-average returns as the global economy grew above trend, inflation was tamed and South Africa reaped the dividends of a normalising society post the advent of democracy. Our younger investor achieved a much more muted outcome, framed by the losses suffered during the global financial crisis in 2008 and the underperformance of the local economy ever since.

VERY DIFFERENT OUTCOMES

JSE performance during initial 10 years of investment



Source: Coronation

The danger of basing your decisions only on personal experience is that you are ignoring 99.9% of the available information. Our two older investors are likely to end up with unmet expectations if they continue to extrapolate the double-digit real returns achieved early in their lives, while our younger investor may end up investing too little if she becomes demotivated after achieving below-average return rates at the outset of her investment programme.

When we extend from the three observations highlighted above to the full historical record (of nearly 1 000 observations), we can say the following about local share investors with 10-year investment horizons:

- South African shares on average returned inflation +8% per annum since 1930.
- The average return since the advent of democracy in 1994 is actually higher, at inflation +10%.
- Over the past 36 observations since July 2015, the return declined to inflation +5.6%.
- The return achieved exceeded inflation around 90% of the time since 1930, and 100% of the time since 1969.
- Longer-term returns tend to mean revert: lower return periods tend to be followed by higher return periods and vice versa.

There is therefore no doubt that the risk-return trade-off has held over time.

DO NOT LOOK BACK, YOU ARE NOT GOING THAT WAY

Since 2013, we have consistently cautioned investors through various platforms (including this publication) to expect more muted returns. At the time our view was driven by the lofty valuations of South African assets as well as our assessment of investor expectations on the back of extrapolated past returns. While this reminder provides cold comfort, the reality is that we are not surprised that investors have been underwhelmed by their return experience over the last three to five years. What is more important now is the view going forward, and in many ways it is more promising. Risk and reward are intrinsically linked, and we are concerned that investors are diluting their ability to participate in the trade-off due to the experience of the recent past. The reality of how markets work means that one's expected return increases as past returns remain lower for longer. We hope that some of the articles featured in this issue of *Corospondent* gives you an idea of the opportunities that can result in improved returns going forward. ✚

Aspen Holdings

A homegrown success story

By Quinton Ivan

"Medicine heals doubts as well as diseases" – Karl Marx

ASPEN HOLDINGS (ASPEN) is a true South African success story. It listed on the JSE in 1998 via a reverse listing into Medhold. Shortly after the listing, it launched a hostile takeover of SA Druggists, acquiring a manufacturing plant in Port Elizabeth and the old Lennon drug business, a pioneer in generic medicines.

Today, Aspen is a supplier of branded and generic pharmaceuticals in more than 150 countries across the world, as well as consumer and nutritional products in selected territories. Through a series of astute acquisitions, it has transformed itself from a domestic company into a global, geographically diversified pharmaceutical company. It has also integrated into manufacturing and operates 26 manufacturing facilities at 18 sites across 6 continents. Its successful integration allows it to leverage its scale to reduce manufacturing and production costs, thereby protecting gross margins – an important attribute as Aspen operates in a highly regulated industry where government usually controls product price increases.

Aspen focuses primarily on niche therapeutic classes such as anti-coagulants, anaesthetics, high potency and cytotoxic products as well as infant nutritionals. These products have several common traits. They are highly specialised and are difficult to manufacture, which protects Aspen from the threat of Asian competitors that >

Quinton is head of South African equity research and co-manages Coronation's Core Equity strategy as well as the Presidio Hedge Fund. He also has research responsibilities for a number of retail, pharmaceutical and construction stocks. Quinton has 13 years' investment experience and joined the investment team in 2005.

tend to focus on simple, long production run products like antibiotics. They are also highly cash generative and post patent, which reduce the risk of a revenue fall-off from generic competition. All product portfolios are supported by a globally integrated, end-to-end value chain that spans product development, manufacturing, distribution and regulatory compliance.

The business has an enviable track record of earnings delivery, generating high returns and throwing off significant cash. It is managed by two of the country's most entrepreneurial managers, Stephen Saad (CEO) and Gus Attridge (deputy CEO), who together own 16% of the company, aligning their interests with that of shareholders. Saad has not sold a single share since listing.

Although Aspen operates in a highly regulated industry, this risk is to some extent mitigated by its extensive geographic footprint, with key markets being Latin America, Europe (West and East), South Africa, Africa and Australasia. There is a significant opportunity to unlock value through bedding down the recent anticoagulant and anaesthetic acquisitions and simplifying the current complex manufacturing process, thereby reducing costs. As both products are primarily dispensed within hospitals, there are scale benefits, as the acquisitions bolster the product basket that sales representatives can use to call on specialists. Aspen has a publicly stated target of delivering at least R2.5 billion of operating income from these initiatives by 2019. They are currently tracking ahead of budget in terms of both quantum and timing, which is material in the context of current group operating income of R9.2 billion.

Furthermore, this business is ripe with optionality, none of which is reflected in the current share price but is encompassed in the company's strategic activities, including:

- The successful launch of Orgaran, a low molecular weight heparin product that is very high margin as it is difficult to produce, in the US.
- The successful launch of infant nutritionals in China (or if Aspen decides to dispose of its infant nutritional division, it is rumoured that it would fetch between $1 billion and $1.5 billion).
- Concluding future acquisitions as multinationals look to exit their tail-end products. (Aspen has a phenomenal track record of concluding value-accretive deals.)

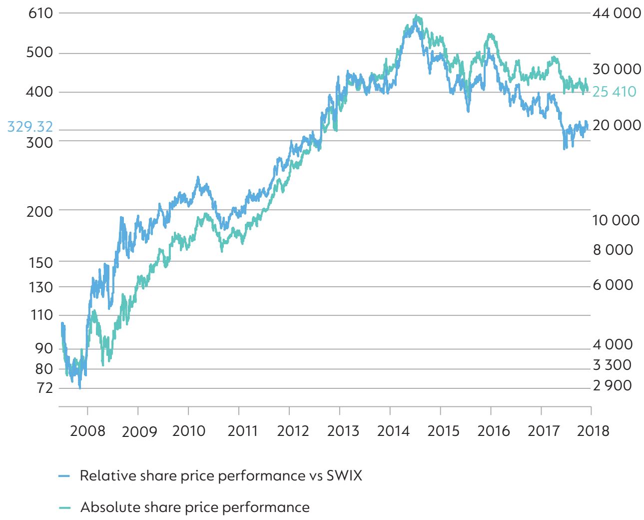
However, despite its fantastic track record and favourable growth prospects, the share has derated significantly, declining by 42% from its peak and underperforming the Shareholder Weighted Index (SWIX) by 47%, as shown in the following graph.

So what exactly spooked the market regarding the Aspen investment case? We address some of the market's key concerns below.

A HIGHLY ACQUISITIVE BUSINESS MODEL, FUNDING ACQUISITIONS USING DEBT

Aspen embarked in earnest on its globalisation strategy around 2009 when it concluded the first of three transformational deals with GlaxoSmithKline (GSK). Post-2009, it globalised at a rapid pace, concluding several large acquisitions with Pfizer, Merck, AstraZeneca and Nestlé.

ASPEN ABSOLUTE AND RELATIVE SHARE PRICE PERFORMANCE



Sources: IRESS, Coronation analysis

Investors should rightly be sceptical of companies adopting a 'roll-up' strategy whereby they are simply acquiring earnings. However, each of Aspen's acquisitions has been strategically sound in our view. Aspen has extracted significant synergies through lowering the cost of goods sold by insourcing manufacturing and simplifying complex production processes. Furthermore, it has invested in its sales force and managed to arrest product declines and grow overall volumes, primarily as these products are rolled out in emerging markets where per capita use is low relative to developed markets.

Aspen is a highly cash-generative business. Members of the management team are significant shareholders and have behaved like true owner-managers over the years. They believe in Aspen's long-term prospects and that its equity is undervalued, and are rightly reticent to issue shares, preferring to fund acquisitions from debt.

Aspen has an internal free cash flow conversion (FCF%) target of 100% of earnings and has exceeded this level historically. FCF% has deteriorated in recent years as many of the large, global deals were consummated over a relatively short period of time, which resulted in a significant absorption of inventory. Site transfers also adversely impacted FCF%, with Aspen shifting production to new sites where it will be able to manufacture products at a cheaper price. This switchover requires the holding of buffer stock to avoid stock-outs – something frowned upon by customers and regulators alike. Working capital is a significant area of management's focus and FCF% should improve significantly going forward, which will allow the business to deleverage. This was evident in the most recent financial results, which saw FCF% improve to 92% of earnings.

A LOW EFFECTIVE TAX RATE

Aspen's current effective tax rate is around 18%. It has declined meaningfully since 2009, the time of the first large, global acquisition. The decline also coincided with the establishment of Aspen

Global (AGI), an entity registered in Mauritius. AGI employs more than 220 people and performs the following group functions:

- Conducts due diligence on all prospective deals;
- Arranges funding for deals;
- Acquires product portfolios from multinationals and owns the intellectual property for all products acquired;
- Assists with all regulatory and compliance matters, especially as these products are launched in new territories; and
- Assists with product transitioning from multinationals to Aspen as well as site changeovers.

It is important to note that AGI owns the global brands; other Aspen companies are thus effectively distributors of these products in various territories around the globe. Consequently, Aspen transfers price to ensure that its pricing is competitive globally. Transfer pricing is a common practice within global pharma and Aspen's tax rate is not out of line compared to other global pharmaceutical companies.

ASPEN'S EFFECTIVE TAX RATE VS GLOBAL PHARMA PEERS

	2013	2014	2015	2016	2017	5-year average
Aspen	21.7%	21.3%	20.5%	29.5%	17.7%	22.1%
Pfizer	27.4%	25.5%	22.2%	13.4%	20.1%	21.4%
Merck	18.5%	30.9%	17.4%	15.4%	21.0%	21.9%
Sanofi	16.6%	21.5%	13.5%	23.4%	20.7%	19.1%
GlaxoSmithKline	23.0%	19.6%	19.5%	21.2%	21.6%	21.5%
Dr Reddy's	19.1%	19.4%	26.3%	19.1%	26.0%	22.1%
Hikma	25.9%	21.7%	18.9%	22.3%	25.7%	22.4%

Sources: Company annual report, Coronation analysis

Aspen's tax structures are not aggressive – they are well within the confines of Organisation for Economic Co-operation and Development (OECD) principles and are compliant with the necessary tax legislation. The South African Revenue Service conducted an international transfer-pricing audit on Aspen a few years back. It subjected the group and its tax structures to significant scrutiny, and found them to be compliant.

It is also important to note that AGI acquired these products from third-party multinationals at the time of acquisition by Aspen. There have not been any off-balance sheet structures or acquisitions from related parties, a consistent theme since the first GSK transaction in 2009. Furthermore, there are no outstanding tax claims or investigations in respect of AGI.

A HIGH INTANGIBLE ASSET BALANCE, THE MAJORITY OF WHICH IS NOT AMORTISED

Aspen has a high intangible asset balance – R60 billion out of R116 billion of total assets – and an equity value of R42 billion. About 88% of these intangible assets are deemed to have an indefinite useful life, which means they are not amortised but tested annually for impairment.

Unlike conventional multinationals, Aspen is not a research and development company. Instead, Aspen's competitive advantage is to acquire and take over manufacturing of technically complex products in specialist areas. Its track record of manufacturing excellence and uninterrupted supply makes it a partner of choice for multinationals looking to exit tail-end products. This strategy derisks Aspen from the boom-bust cycle of new molecule launches.

All products that Aspen acquires are post patent, which means they have already been amortised by the originator over the patent period. As a result, Aspen's accounting treatment is not directly comparable to that of an originator company amortising products that are still under patent protection. The carrying value of Aspen's intangible assets is conservatively struck considering:

- Impairments over time have been minor due to Aspen's established track record of arresting and then growing once-declining products and reducing cost of manufacture.
- Intangible assets have never been revalued higher; they can only be impaired.
- R60 billion of intangible assets support R90 billion of revenue – Aspen's carrying value implies conservative valuations relative to earnings generated from its acquisitions. Elsewhere in the industry, transactions regularly occur where pharmaceutical products are acquired at significantly higher multiples.

REGULATORY RISK: INVESTIGATIONS INTO EXCESSIVE PRICING IN THE EU AND UK

Aspen is currently under investigation for alleged abuse of dominance and excessive pricing. This relates to products that have a minor contribution (less than 3%) to group revenue, so any potential impact is likely to be insignificant. More importantly, these allegations should be viewed in the context of these products not having a price increase for nearly three decades. As a result, these products should either be priced for viability or discontinued. The fact that no new competitor products have been launched post these price hikes indicates that current pricing is not excessive and Aspen is not earning super profits. Furthermore, the allegations are contradicted by the Italian regulator's recent approval of a generic product that sells at a higher price than Aspen's product.

Heightened risk aversion has caused investors to ignore Aspen's fantastic track record and the ability of its management team to create value for shareholders. This has resulted in indiscriminate selling of its share, creating a disconnect between the current share price and its intrinsic value. Aspen trades on an attractive one-year forward price earnings of 13.5 times and 10 times our assessment of normal earnings. It offers compelling value, and investors who are able to set emotion aside and cut out the noise have a high probability of being rewarded handsomely. ✚

Going with the stream

Spotify and Apple Music lead the revival of the recorded music industry

By Chris Cheetham

Chris joined Coronation in June 2017 as an investment analyst in the Global investment team. Chris has 7 years' investment experience, is a qualified chartered accountant and a CFA charterholder.

NOT MANY YEARS have songs named after them, but Prince's apocalyptic hit "1999" defined a moment in time for many – including the entire recorded music industry. The year marked the peak in global album sales, with overall industry revenue subsequently dropping for almost two decades due to piracy and the unbundling of the album.

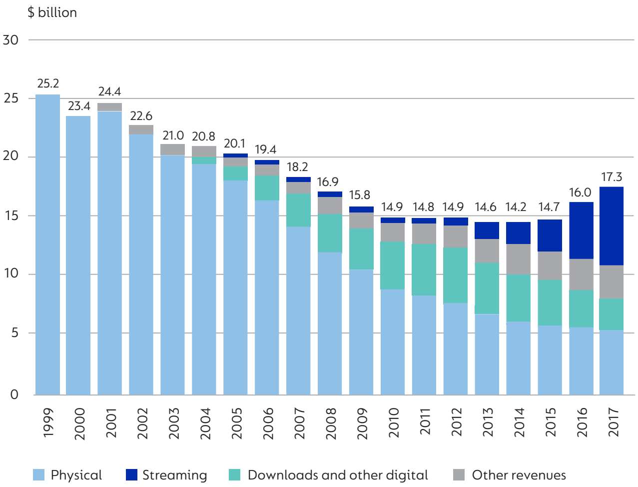
But a turning point has been reached, with streaming revenue growth offsetting declines in physical album sales and downloads. Today, industry revenue is still a third lower in nominal terms than in 1999, but since 2015 the industry has bounced back and the return to growth has now started to accelerate.

What contributed to the decline, why do we think the recovery is sustainable and who is expected to benefit?

THE MONETISATION GAP

The file-sharing platform Napster was launched in 1999, making it easy to exchange files while completely disregarding copyright laws. Lawsuits against the company only brought free publicity and soon university networks were clogged with MP3 file transfers as Napster reached 80 million users at its peak. Napster was ultimately shut down in this form, but it ushered in a plethora of similar sites, leading to an eruption of piracy that rattled the music industry to its core.

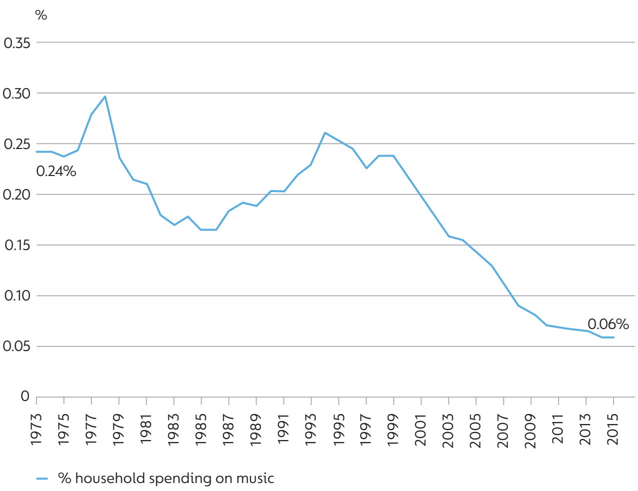
GLOBAL RECORDED MUSIC INDUSTRY REVENUES 1999-2017



Source: International Federation of the Phonographic Industry (IFPI)

Album sales plummeted and the music industry, long very cushy and borderline complacent, struggled to adapt to the 'new normal'. To compete, paid downloads seemed the only viable option, offering consistent sound quality and a clear conscience as value propositions. Hindsight is always perfect, but this was a poor response and further disrupted the industry, effectively unbundling the album and enabling the cherry picking of tracks, with very negative effects on revenue. It also created a restrictive experience for the consumer with tracks stuck on certain devices, while inertia to spend a dollar on a single song meant that the lure of piracy remained.

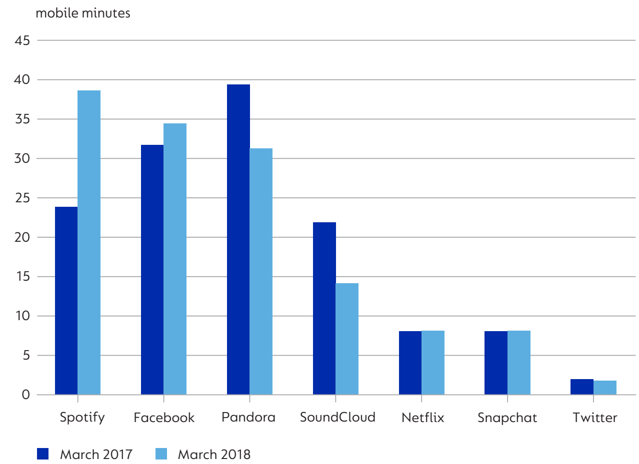
PERCENTAGE OF US HOUSEHOLD SPENDING ON MUSIC 1973-2016



Sources: Bank of America (BofA) Merrill Lynch Global Research, Recording Industry Association of America (RIAA) US Sales Database

YouTube emerged around the same time and established itself as a viable platform for music video streaming. Legendary record producer Jimmy Iovine estimates that 40% of all music listening today takes place via YouTube – a number confirmed by other sources – but it pays less than its fair share to the music industry. At the time, the music industry was forced to make original music videos available to YouTube on the basis that some revenue was better than nothing. The industry had its back against the wall.

MOBILE MINUTES SPENT PER DAY ON EACH SERVICE



Sources: comScore, Goldman Sachs Research

THE STREAMING OPPORTUNITY

People did not stop listening to music, they just stopped paying for it – with piracy and YouTube filling the gap. Estimates from market research firm Nielsen show continued increases in consumption, with Americans currently listening to around 30% more music than they did in 2015. Streaming is making it easier to listen to music and is expanding the overall market. Critically, it has finally provided the industry with an attractive means of monetisation.

People are embracing paid streaming because it is a great service at a reasonable price. In the developed world, $10 per month will buy you access to over 35 million tracks available at any time and on any device. Family and student plans are available at around half this price. It is easy to search and find songs, there are curated playlists tailored to your tastes, and you can download and play songs offline. Crucially, sound quality is first-rate and consistent. As such, users are engaged and spending an increasing amount of time listening to music via their mobile phones.

Streaming also fits squarely into changed consumer preferences, first towards mobile and secondly towards subscription as opposed to ownership, which is a key millennial trend. The shift to mobile is evident in all technology companies and has been a key enabler for streaming acceptance. Users can now hold their entire music library in one hand and listen to it via a myriad of Bluetooth >

speaker options, which are steadily improving. Voice-controlled devices enabled by the likes of Amazon's virtual assistant Alexa should reduce the friction of song search, making the listening experience more enjoyable and helping to drive growth. Piracy remains a key risk, but it is becoming increasingly 'not cool' among younger consumers, and we believe that when shoppers are given the option of a quality service that satisfies their needs at a fair price, they will pay for it.

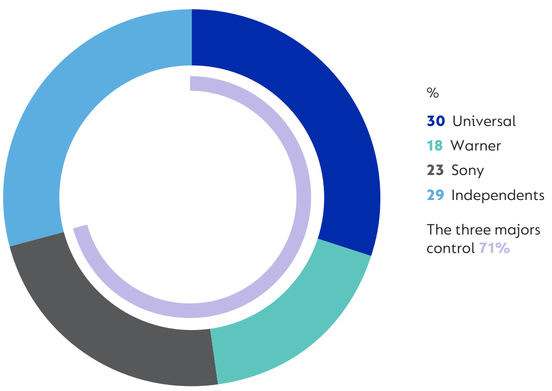
The number of paid streaming subscribers globally has exploded to almost 180 million at the end of 2017. Spotify is the market leader and currently boasts over 70 million paid subscribers. It expects to end this year with over 90 million, taking advantage of the strong structural growth drivers in the industry. With an additional 100 million ad-supported subscribers, one must not underestimate the amount of data that Spotify collects, enabling it to curate music in an extremely cluttered environment where thousands of tracks are added every week.

We see tremendous value in UMG's music catalogue – it is the world's largest and continues to earn revenue from artists like The Beatles, Elton John and Queen.

SO WHO OWNS THE MUSIC?

Streaming platforms such as Spotify and Apple Music are synonymous with music today, but the three large record label groups Universal Music Group (UMG), Sony and Warner currently own the majority of the world's music. UMG, owned by the French-listed Vivendi, is the largest of the three and arguably the only investable record label group. Sony's music business makes up only a small portion of the sprawling conglomerate's earnings and Warner is privately owned. UMG owns iconic record labels like Geffen, Def Jam and Capitol Music Group, and represents leading artists such as Drake, Justin Bieber and Rihanna.

RECORDED MUSIC CONCENTRATION



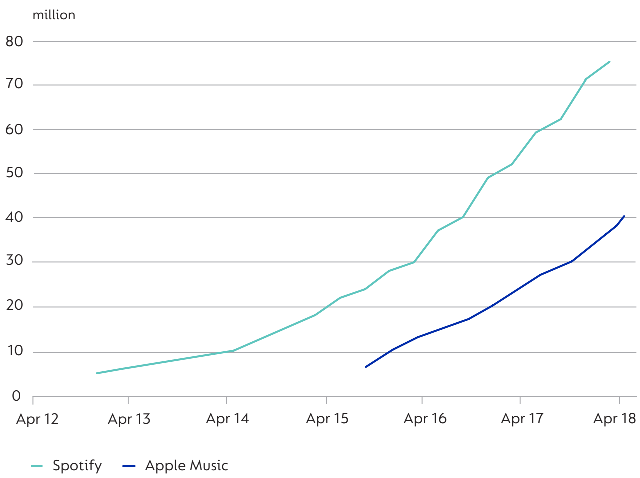
Sources: IFPI, company filings

So far, streaming has been a successful model for the music industry. It has evolved the industry from one-off album sales to annuity income, with revenue visibility from monthly subscription fees. Recorded music is now a less hit-driven business than in the past, as streaming allows the artist, label and platform to monetise a fan over her entire lifetime rather than in a single transaction. Unlike watching movies or TV series, we listen to our favourite songs over and over again. In fact, tracks older than 18 months account for the majority of listening time on streaming services such as Spotify today. As such, we see tremendous value in UMG's music catalogue – it is the world's largest and continues to earn revenue from artists like The Beatles, Elton John and Queen.

For every $10 paid to Spotify, around $5.50 goes to the record label, which then pays the artist it represents. It is the label's job to discover new artists and to finance them, providing creative expertise, studio time and access to songwriters and composers along the way. Labels are also responsible for promoting and marketing artists, ensuring that their music is distributed on streaming platforms, radio stations and in record shops around the world. They also collect and manage royalties from numerous sources. $1 then finds its way to the publisher, who represents the songwriter. Spotify only retains $3.50 in its capacity as distributor. There are no fixed dollar payments to artists; instead, the total revenue generated by the platform is shared out in these ratios and artists are paid in proportion to song play. The revenue pie is growing rapidly, and artists are increasingly embracing this new business model.

Streaming platforms such as Spotify and Apple Music have led the resurgence of the music industry. Looking ahead, could these platforms backward integrate, producing their own music and disrupting record labels just as Netflix displaced traditional entertainment studios?

STREAMING MUSIC PAID SUBSCRIBERS



Sources: Company reports and announcements, Atlantic Equities

Music differs from audiovisual content. We listen to our favourite tracks repeatedly, making the back catalogue very important. People also consume music more regularly, and every streaming platform needs every good track to be appealing. A prisoner's dilemma has emerged, with the labels needing the platforms for distribution and the platforms needing the labels for content. With a delicate balance required, a semi-collaborative approach has emerged, with the aim of growing the market.

We expect platforms like Spotify to gain more power over time as they increasingly influence user demand and control a rapidly growing share of music distribution. We also expect Spotify to produce its own content around the fringes, but believe full-scale record label disintermediation is highly unlikely, with the big three labels still controlling over 70% of the world's recorded music, including the valuable back catalogues.

While the music industry is not yet 'partying like its 1999' again, it is in the very early stages of revival. We expect content owners and streaming platforms to thrive going forward as the industry recovery continues. Coronation owns both Vivendi and Spotify in its global funds. ✚

Treasure hunting

The value of proprietary, deep-dive research

By Greg Longe

Greg joined Coronation's Global Frontiers investment unit in February 2013 as an investment analyst. He studied at the University of Cape Town where he completed a Bachelor of Business Science in Finance degree in 2008 and a post-graduate diploma in accounting in 2009. Greg completed his audit training at Ernst & Young. He is a CA (SA) and CFA charterholder.

HUNTING FOR TREASURE (or undervalued shares) often takes you to unusual locations. Lyn's Bar VIP was no exception. Looking around me, I realised that 'bar' was perhaps too strong a word, 'VIP' definitely so. Upturned empty crates masqueraded as chairs around a mismatched collection of tables. The few patrons present lolled stretched out across the battle-weary bar, staring quietly into half-empty quarts of beer. It was only 10 a.m. but business had already begun. Or perhaps it had continued from the Tuesday night before. Posters, colours long faded, advertising a plethora of beers, musicians and now ancient sports stars, adorned the otherwise tired, grey walls. A fridge stood in a corner, light flickering. In walked Lyn, the lady I have been waiting 30 minutes to see. Finally, the work could begin.

A key part of our long-term, valuation-driven investment process is our proprietary research. It is this thorough, rigorous and in-depth work that helps us arrive at our estimate of a stock's fair value. And it was this research process that took me to Lyn's bar in Yopougon, a sprawling, mostly low-income suburb of one million people in Abidjan, Cote d'Ivoire.

Cote d'Ivoire on the West African coast is a country of 25 million people that has enjoyed an economic boom following a civil war that ended in 2011. The IMF expects the country to see average GDP growth of 6.8% per annum to 2023 – the 11th highest in the world. The beer market has long been controlled by Solibra, a subsidiary of the global Castel group. Markets with large, growing populations and strong GDP growth controlled by a monopoly brewer are typically very attractive ones for investors. Our interest was first piqued last year when our screening tools revealed that Solibra was trading on valuation multiples well below its global frontier brewing peers. It was time for the treasure hunt to begin.

We quickly did some further work and realised that information on the company was scarce. The four-page annual report was all in French, there was one sell-side analyst covering the stock and the website had little information. While this was an example of a particularly limited company profile, scarcity of information is not unusual in many of the global frontier markets where we invest. Often the lack of information creates both a sense of frustration and an opportunity. It was highly likely that any market or company research we did would not be widely appreciated or reflected in share prices. Inefficient markets create opportunities for the active investor.

At the time, Solibra's share price had sold off by about 30% over the past year. The investment opportunity was beginning to look very interesting. A monopoly brewer in an attractive market where there appeared to be mispricing due to market inefficiency warranted a closer look. It was time to do some detailed work on the company.

The following weeks saw us talk to a number of experts in African beer markets, begin building a valuation model and do as much Cape Town-based research as we could. It quickly became apparent that the reason for the share price moves was that Heineken was about to enter the market with a brewery in Abidjan. This did not immediately scare us off. We had seen competition enter monopoly beer markets before, often with limited success. Typically the barriers to entry in the beer industry are high and a well-run, aggressive incumbent can usually keep the new entrant at bay. We surmised that Heineken would likely gain a small market share, say 10% or 15%, a level at which it would struggle to make an adequate return on investment. Solibra would see a year of disruption, maybe take a small step back in profitability and then it would be business as usual again. With the share down 30%, the market was clearly pricing in a much direr outcome, which was surely an overreaction. The only way to be sure, though, would be to visit the market and do some on-the-ground research.

Flights were booked, bags packed, meetings arranged and schedules planned. The three days passed quickly; a whirlwind of sights, sounds and experiences. While no one from Solibra was willing to meet with us, the interviews we conducted with ex-employees, competitors, distributors and retailers (like Lyn's Bar VIP) proved invaluable. The message from Yopougon, from Cocody, from Marcory and the other neighbourhoods we visited was the same. The situation in Cote d'Ivoire was far worse for Solibra than we had initially thought. Heineken's entry was likely to have a much bigger impact on the beer market. While the Solibra share price had already fallen 30%, earnings were likely to come under significant pressure. Adjusting for our new outlook, Solibra no longer looked cheap; in fact, it looked expensive. Following the trip we decided not to invest in the company as the valuation was not compelling enough. That was August 2017. The share has fallen 50% since then.

While we will be the first to admit that we by no means get the investment call right all the time, this was one example of many where our detailed research process enabled us to avoid losing the capital entrusted to us by our clients. Also, it is not always about flying halfway across the world to do the work, as the next two examples show.

We met with a Greek jewellery retailer called Folli Follie in Cape Town last year. We were excited ahead of this meeting, since the company looked very cheap and the business prospects attractive. However, after the meeting and several discussions with industry experts, we decided not to invest in the company. While there was a lot to like, we were not able to sufficiently ease our concerns around the retailer's poor cash generation or understand the mismatch between the reported revenue growth and industry experts' more bearish outlook on Folli Follie's brands.

Our decision not to invest proved to be the right one when a short seller's report came out in May this year questioning the company's results, with numerous accusations made, including that store numbers were in fact much lower than reported. Since then, the share price has fallen more than 70% and trading in the share has been suspended. The company is strongly refuting the various allegations in the report, and investigations and audits are ongoing. We truly hope that the company will be able to demonstrate that the financial statements were not maliciously misstated. Only time will tell.

While many people might see high profit margins as a good thing, we view it as a big risk when we cannot fully explain why a business should be so much more profitable.

Finally, a last example worth mentioning is Pak Elektron, a manufacturer of appliances and electrical equipment in Pakistan. At first glance this company also looked interesting. The company traded on a single-digit price earnings multiple, and as a beneficiary of Pakistan's investments in the power sector, the business was growing strongly. However, when we compared the profitability of the company to similar businesses around the world, we saw that this business was significantly more profitable. While many people might see high profit margins as a good thing, we view it as a big risk when we cannot fully explain why a business should be so much more profitable. We did a deeper dive into the financials and conducted interviews with management and other sector participants but could not get the requisite comfort. We decided not to invest.

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In February 2018, the World Bank announced that Pak Elektron had been debarred from participating in World Bank-financed projects for a period of 33 months due to collusive practices during bidding processes. The share price is currently down 50% since we first looked at the business in 2016. Although our research did not specifically identify collusive practices, we are heartened by the fact that the red flags we identified, similar to the concerns we identified in the case of Folli Follie, ensured that we avoided a large loss of capital.

The trip to Lyn's Bar VIP did not ultimately result in a new share in the portfolio. But unlike treasure hunting, it is both what you choose to buy and what you choose *not* to buy that matters for the portfolio investor. Spending hours researching a company only to conclude not to invest can sometimes be a bit disappointing. Ultimately though, safeguarding our clients' capital remains front of mind. In all markets, but especially those like global frontier markets where information is scarce, our proprietary, deep-dive research-driven investment process adds significant value. ✚

SOUTH AFRICAN ECONOMY

Realism sets in

Despite positive moves, South Africa's fiscal position is still very vulnerable

By Marie Antelme

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

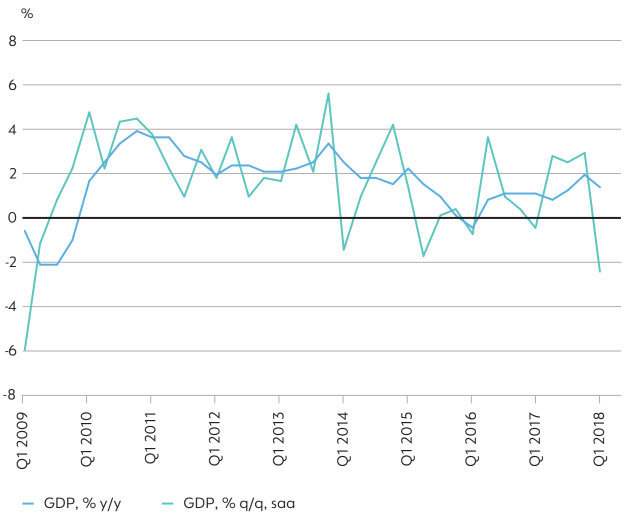
ECONOMICALLY, IT HAS been a very disappointing start to the year. After a long period of political and economic deterioration, the fast pace of political change after the ANC elective conference in December should have heralded the start of a recovery in confidence and growth. And in part, this did happen – president Ramaphosa moved swiftly to appoint a cabinet which mostly replaced poor ministers with good ones, the Budget delivered a decent political commitment to consolidation, Moody's not only did not downgrade the sovereign rating to subinvestment grade, it moved the outlook to stable, and consumer and business confidence improved visibly. But growth did not.

WHAT HAS HAPPENED?

GDP growth contracted in the first quarter of 2018 by -2.2% quarter on quarter (q/q) seasonally adjusted and annualised (saa) and was just 0.8% year on year (y/y). While data from the fourth quarter of 2017 were particularly strong (surprisingly so, given the >

prevailing political uncertainty at the time), high-frequency data published in the first quarter of 2018 suggested that activity was a lot slower at the start of the year, and that the degree of deceleration was greater than expected. The biggest detractor was a 24.4% q/q saa contraction in agricultural production, which cut 0.7% off growth. Both mining and manufacturing output was significantly weaker following a surge in the fourth quarter of 2017, but weakness in other sectors, including utilities and construction, was more pronounced than expected. In particular, activity in the tertiary sector of the economy stagnated, with some resilience in finance and government the only real light spot overall.

GDP, % Y/Y AND ANNUALISED



Source: Statistics South Africa

Looked at from the expenditure side of the economy, fixed investment was surprisingly weak, falling -3.2% q/q saa, up just 0.2% y/y off a weak base. Again, the acceleration in the fourth quarter was stronger than expected. Another big disappointment came in with a fall in exports of -16.5% q/q saa and a total detraction from growth by net exports of -3.1 percentage points. Elsewhere, household spending slowed to 1.5% from 3.6% q/q saa. Accounting for 60% of real GDP, this is traditionally an important driver of growth momentum, and while the absolute rate of growth is a little weaker, it remains resilient – the slower moderation in the first quarter of 2018 is not surprising given the fourth-quarter surge.

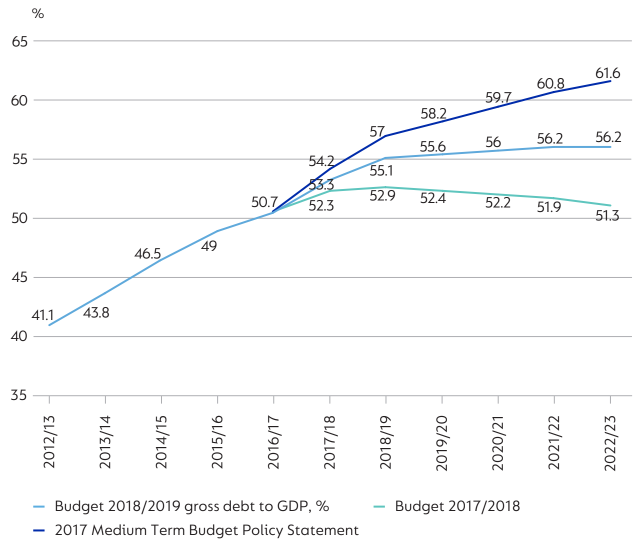
The weakness in net exports points to a widening current account deficit and may temper growth expectations further. While global activity slowed in the first quarter and is also expected to rebound later in the year, this remains a vulnerability, not only for better growth but also for the currency.

Looking ahead, there is good reason to expect growth to improve from here, albeit at a slower pace than hoped. First, data from the first quarter of 2018 were affected by a number of one-offs which should recover, including the impact of a smelter outage on platinum group metal output (23.3% of mining production), an oil refinery closure which handicapped manufacturing output, and seasonal adjustment related both to Black Friday retail spending late last year and the timing of the Easter holiday this year.

While high-frequency data for the start of the second quarter of 2018 have continued to disappoint (retail sales, mining, manufacturing, business and building confidence), households in particular are in a relatively good position to increase spending, with solid real wage growth seen, improved consumer confidence and reasonably solid credit metrics emerging in data from the National Credit Regulator. Growth of above 2% in household spending remains a reasonable expectation at this time.

A meaningful productivity and job-generating increase in capital investment is likely to take longer. It is the nature of large industries in South Africa to require long lead times for investment, and despite the changing political backdrop, policy in key sectors remains uncertain. The renewed debate about land expropriation is unhelpful too, and it seems likely that companies will need more certainty (and durable global demand) to generate meaningful capital commitments. That said, even a small increase in inventory accumulation could provide some short-term growth momentum.

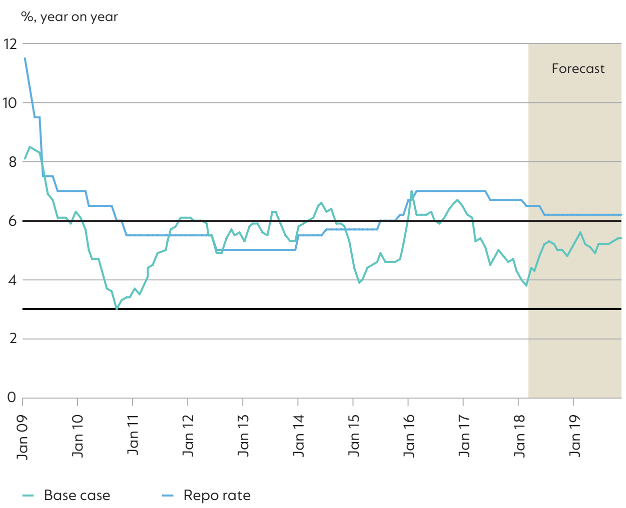
SOUTH AFRICA'S DEBT TO GDP



Source: National Treasury

With growth disappointing, other concerns have become more heightened. South Africa's vulnerable fiscal position was rendered only slightly (and possibly temporarily) less so with the Budget that was tabled in February, and the decision to support revenues with a 1% increase in value-added tax. Sustained consolidation of the deficit and moderation in the pace of debt accumulation, which accelerated meaningfully after the financial crisis in 2009, require both an improvement in the pace at which revenue is collected as the economy grows (tax buoyancy) and a tight rein on expenditure, notably the wage bill. Low growth threatens the former, although there are some signs of improvement here. On the latter, the public-sector wage agreement, which almost resulted in a strike, was a little more generous than budgeted, and will add to expenditure over the next three years. While this is not yet enough to fully undermine Budget projections of a deficit of -3.6% of GDP this year from -4.3% last year, the added burden of state-owned entities under significant pressure means that South Africa's fiscal position is still very vulnerable.

CPI INFLATION PLUS FORECASTS



Sources: Statistics South Africa, Coronation

On a positive note, inflation remains very benign and interest rates should stay low. Available data suggest CPI will average about 4.8% this year, with a small tick up in 2019 to 5.2%. Low food inflation is the main anchor to inflation, but tail winds from the currency's strengthening at the start of the year can be seen in goods inflation, which is running at just 3.5% y/y. Services inflation has also moderated and is typically a slow-moving indicator; it should remain well contained in coming months. The biggest risk to inflation comes from a combination of the weaker currency and high international oil prices, although at this stage these are unlikely to be enough to unanchor headline inflation meaningfully above target, or, in our view, prompt a tightening in monetary policy at this stage.

HOW TO THINK ABOUT THE ECONOMY GOING FORWARD?

The weak economic outcomes are a reality check, a reminder that the deterioration in political and economic conditions has taken time, and so will the remedy. At the end of the day, the practical reality of a weak economy in which both consumers and businesses have suffered low or contracting growth in an increasingly unstable political environment has created a situation where intent and feeling better are not enough to motivate spending.

To give credit where it is clearly due, a lot has happened to halt the deterioration in both political and macroeconomic variables. Significant changes have been made at both ministerial and institutional level, and various regulatory and governance changes were initiated to start healing ailing parts of the system. Committed political and business leadership has worked tirelessly to not just talk about these interventions, but to deliver justice and generate committed capital. However, this process was never going to be easy or straightforward, and we are reminded daily that not everyone wants the same thing – vested interests, poor practice (both public and private) and deeply ingrained but differing perspectives are all challenges which will need to be navigated to see an economic recovery.

For the remainder of this year and the next, with many uncertainties not limited to internal political dynamics, the 2019 election and global cyclical momentum, domestic fundamentals still support better growth than we have seen to date. Aside from the one-offs which we expect to reverse by the end of the first half of 2018, we anticipate a pickup in household spending, an area of resilience in the first quarter, and some improvement in net trade. We think capital investment will be less weak, but will take longer to recover, with growth forecast at 1.6% this year (1.8% previously) and a solid 2.2% in 2019. ✚

Quo vadis?*

Local yields become attractive as emerging market bonds tumble

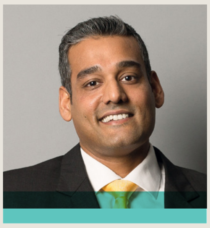
By Nishan Maharaj

WHAT A DIFFERENCE a few months make. By the end of the first quarter of 2018, the world was in a happy place. Emerging markets were forging ahead, generating bond returns of 4.4% and equity returns of 1.4% (both in US dollar terms), and synchronous global growth was the rising tide that would lift all boats. Fast forward to the end of the second quarter and tears of disappointment are rolling down the faces of most emerging market investors. The sweet nectar that enticed and fuelled an insatiable hunger for yield in developing markets started to sour towards the end of April.

* Moving in a herd has its advantages. It is difficult to get lost; all you have to do is stick to whoever is in front of you. Following the herd works out for some, but not for others. Large fluctuations in the market always tempt investors to follow the herd. Nevertheless, as with the 'lemming' metaphor so widely (ab)used, sometimes staying with the herd can be the first step towards the afterlife.

Coronation's proprietary research process, which has a 25-year track record, focuses on deep, insightful research into the long-term fundamental drivers of the local economy and the pricing of assets based on the long-term prospects for the economy. This ensures that our investment decisions are independent, durable and based on our assessment of long-term value for our client portfolios.

Nishan is head of Fixed Interest and responsible for the investment process and performance across all portfolios within the fixed interest offering. He has 15 years' investment experience.



Emerging market assets tumbled, spurred on by concerns of an overheating US economy and fears around the escalation of a US/China trade war, in turn fueling a rally in the US dollar. This resulted in emerging market bonds and equities losing between 8% and 10% in the second quarter of 2018, bringing their dollar returns for the year-to-date to -6.44% and -6.60% respectively.

The spirit of 'Ramaphoria' that prevailed during the first quarter of 2018 lost its momentum. In part, this was driven by disappointing growth data and a slowdown in the pace of policy reform implementation (as highlighted in last quarter's Bond Outlook). Coupled with the souring global environment for emerging markets, this resulted in the All Bond Index (ALBI) falling 3.8% in the second quarter of 2018, bringing its return year-to-date to 4% (marginally ahead of cash at 3.6%), but maintaining a solid double-digit return of 10.2% for the 12-month period.

The South African 10-year government bond benchmark yield rose by almost 1% to 8.84% at the end of June (from its first quarter closing level of 7.98%), touching an intra-quarter high of 9.15%. The liquidation of bond holdings by foreigners resulted in a substantial swing in net bond flows, moving from a year-to-date net inflow figure of R17.6 billion (at 31 March 2018) to a net outflow of R35.6 billion (at end-June 2018). This had a significant impact on the exchange rate, with the rand weakening by 13.7% over the quarter.

POSITIVE LOCAL BACKDROP FOR SOUTH AFRICAN BONDS

The local economy has endured an extended period of underperformance relative to global markets and its peers in the emerging market universe. More recently, many of South Africa's self-imposed obstacles have started to show signs of clearing. Inflation remains at a cyclical low and should not exceed the top end of the South African Reserve Bank (SARB) target band (3% to 6%) over the next 12 to 24 months. In fact, current inflation expectations are closer to 5% than 6%, according to the latest Bureau for Economic Research Inflation Expectations Survey.

Growth numbers for the first quarter of 2018 surprised materially to the downside (-2.2% quarter on quarter and 0.8% year on year), calling into question the realism of the 'Ramaphoria' effect. This implies that the SARB has room to provide more cyclical support to the local economy by further easing the repo rate; however, considering the recent rout in emerging markets, the worst-case outcome is that the repo rate remains stable for at least the next 6 to 12 months.

On the growth front, although most recent data are cause for concern, real consumer income growth will be closer to 2% this year, allowing for an additional recovery in consumer spending, which makes up about 60% of GDP. Long-term growth prospects will rely on an increase in fixed investment into the local economy, which can only be realised in a certain and transparent policy environment. The conditions thereof have been partially met with the new administrative team in government and newly announced policy reforms – although these reforms are likely to be implemented at a much slower pace than suggested at the start of the year. This leaves the South African economy in a very favourable position relative to its peer group, with growth heading higher and inflation being stable (or lower), creating a supportive environment for local bonds.

Despite the positive local backdrop for South African bonds, the global environment has become unsympathetic as global monetary policy accommodation continues to be wound down. As such, the price one pays for South African government bonds should encapsulate a decent margin of safety to weather short-term market volatility. There are two key measures through which to assess the value in local bond markets; first, by comparing the implied real yields of local government bonds relative to their emerging market counterparts as well as their own history, and secondly, by establishing whether current yields provide a sufficient margin of safety should one of the key underlying drivers (the one that is currently most at risk) experience an abrupt, adverse move.

In the graph below and the table overleaf, we compare the implied real yield of the South African 10-year benchmark to its history and relative to its emerging market peers. We arrive at the implied 10-year real yield by adjusting the nominal 10-year yield for the average actual realised inflation over the two years after the observation point (we use a combination of market and internal forecasts for those periods where this is not available).

As an example, a nominal 10-year yield of 9.04% at 29 June 2018, adjusted by an expected inflation average of 5.1% over the next two years, implies a real yield of 3.46%. Two things are clear from this exercise. First, the current level of real yields in South Africa is attractive relative to history. The graph below shows that real yields are sitting above their 10-year average and are as high as they were during previous times of locally driven economic and political stress.

Secondly, relative to our emerging market peer group, South Africa flags as one of the cheapest stable emerging markets, both from a real and nominal yield perspective. We remind readers that both Brazil and Turkey are at very different points in their respective business cycles to South Africa and are going through a period of unsettling economic and political stresses. Therefore the relative valuation of South African government bonds seems relatively cheap.

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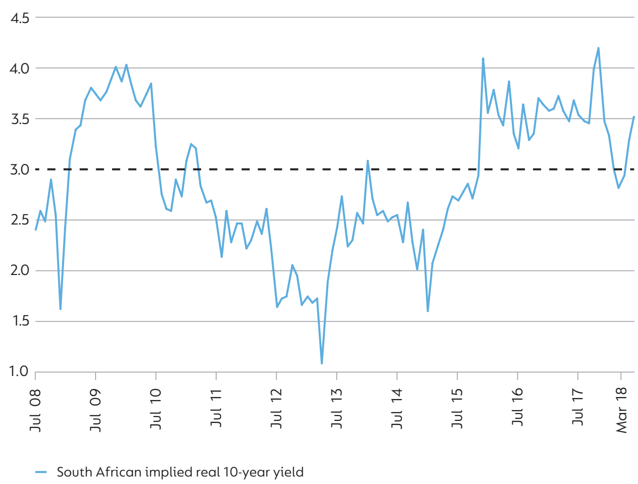
CURRENT REAL YIELDS ATTRACTIVE RELATIVE TO HISTORY



Source: Bloomberg

SOUTH AFRICAN 10-YEAR NOMINAL AND REAL YIELDS CHEAP RELATIVE TO PEERS

	Nominal yield	Implied real yield
Turkey	16.01	5.46
Brazil	11.68	4.37
South Africa	**9.04**	**3.46**
India	7.90	2.09
Indonesia	7.74	3.19
Russia	7.68	2.13
Mexico	7.60	3.42
Average	6.45	2.20
Chile	4.59	1.52
Malaysia	4.20	1.62
Hungary	3.62	0.87
China	3.48	1.20
Poland	3.21	1.11
Czech Republic	2.01	0.02
Israel	1.72	0.46

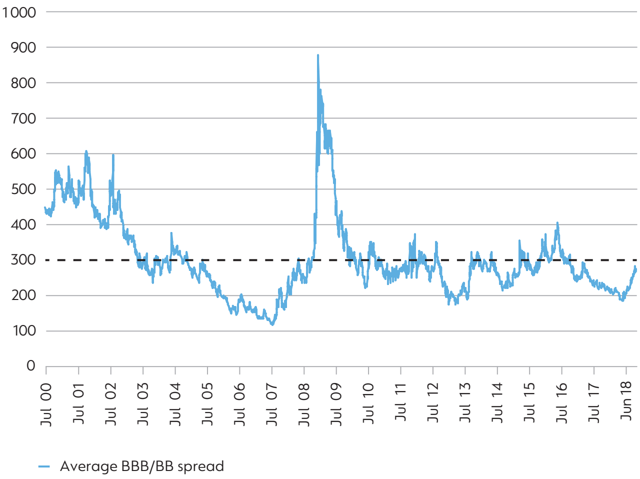
Source: Bloomberg

To arrive at a fair value for South African government bonds, one must take into consideration the following three things:

- The level of the global risk-free rate;
- The inflation differential between South Africa and the rest of the world; and
- A credit spread that quantifies the inherent risk in South Africa as an issuer among emerging markets.

We can objectively say that the current level of the South African 10-year bond is 9.04%, the global risk-free rate is 2.86% (US 10-year) and the inflation differential is sitting at 3% (local inflation of 5% and US inflation of 2%). This implies a credit spread of 318 basis points (bps) for South African government bonds. The graph below shows the average credit spread for BBB (investment grade) and BB (first rung of subinvestment grade) borrowers. It must be noted that South Africa has a split credit rating, with Fitch and Standard & Poor's holding a subinvestment grade rating while Moody's holds an investment grade rating for South Africa. The current level of the average credit spread in the graph is 270 bps, with a long-term average (the black dashed line) of 300 bps. We conclude from these observations that South Africa trades quite cheaply relative to its peer group. Even if credit spreads were to normalise further as global monetary policy conditions tighten to long-term averages, the country's current credit spread provides sufficient room for a cushion against this normalisation, given that it currently trades well above the long-term peer group average.

TRADING QUITE CHEAPLY RELATIVE TO PEER GROUP

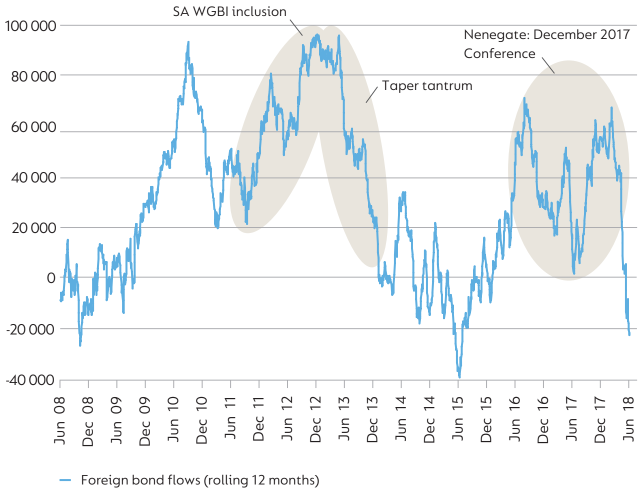


Source: Bloomberg

Foreign flows into the local bond market garner a great deal of attention due to their magnitude, but they do not form part of the foundation of our investment case for bonds. We focus on the pricing of risk rather than the psychology surrounding risk. Nonetheless, looking at the trends does provide some insights. The current level of outflows, on a rolling 12-month basis, is equivalent to the level of outflows that the bond market experienced during the period May to June 2013 (the 'taper tantrum') and in the aftermath of 9 December 2015 ('Nenegate'). There are two key observations to be made from the graph below:

- Foreign flows in/out of the local bond market are generally driven by momentum (buying as the market becomes more expensive, or selling as it becomes cheaper), making them a poor indicator of future market performance.
- Given the degree of selling that has been experienced over the last 12 months (more specifically in the last three months), positioning seems a great deal cleaner (that is, not biased to a sell-off or rally in markets). This further suggests that big moves going forward are more likely to be valuation based rather than sentiment/positioning based. This further adds credit to our assertion that from current levels, bond yields are more likely to compress (bond rally) than widen (bond sell-off).

FOREIGN BOND FLOWS – A POOR INDICATOR OF FUTURE MARKET PERFORMANCE



Source: Bloomberg

South Africa has made the mistake of looking through rose-tinted glasses for the better part of this year, with asset prices reflecting a much too optimistic outlook for local economic developments. The recent economic disappointments with regard to growth have been a stark reminder of the local economic reality against a global backdrop that has turned more treacherous for emerging markets. South Africa's underlying economy remains in a better place relative to history and to its peer group. Inflation is expected to remain stable and well contained, while growth will continue to move higher. Local bonds have now adjusted to reflect realistic expectations for the local economy and the more unfriendly global environment. South African bonds compare favourably to their emerging market peers, relative to their own history, and offer a decent cushion against further global policy normalisation. At current levels, the yields on offer in the local bond market are attractive relative to their underlying fundamentals and warrant a neutral to overweight allocation. ✚

Will politics disrupt the global recovery?

Current high levels of tension fuel uncertainty

By Marie Antelme

AFTER THE LAST few weeks, it is hard to know how to think about the outlook for global growth. On the one hand there is a good amount of data showing that global activity – led by the US – has picked up after the first-quarter malaise, although Europe and Japan have yet to fully recover their lost momentum. On the other hand, an escalation in political tensions, led by but not limited to trade relations between the US and its various trading partners, pose a meaningful downside risk to the improved outlook. To make things more complicated, it is also unclear to what degree the rise in trade tensions may be fueling the escalation in short-term activity, as producers act in anticipation of rising costs, and what this could mean for growth, policy setting and asset markets in the medium term.

At the time of writing, the first round of tit-for-tat tariff increases on a cumulative $100 billion between the US

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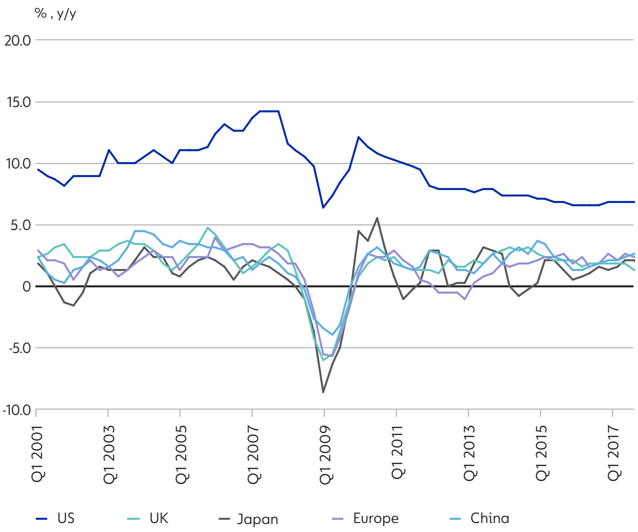
and China has been implemented. More importantly, there are clear signs of this escalating. Not only has president Donald Trump announced his intention to add a further $200 billion on a wider range of targeted Chinese imports, he has also reiterated his threat to impose tariffs on all vehicle imports to the US, with the notable inclusion of the EU. He has criticised UK prime minister Theresa May's 'soft Brexit' proposal and has appeared to criticise US investigative agencies in support of Russian president Vladimir Putin.

Initial estimates of the direct impact of the first round of tariffs was reasonably limited at 0.1 percentage points of global GDP, while the second round estimates are closer to 0.5% over the next two years, according to the IMF. The knock-on effect through the disruption of globally integrated supply chains and confidence, and the lingering effects of uncertainty could be significantly bigger. While the issues related to trade hold potentially meaningful implications for global growth, the second round of tariffs creates a new paradigm of geo-political uncertainty, which is hard to assess but certainly challenges the assumed balance of global power of the past.

As these new dynamics start to play out, global economic fundamentals are reasonably sound. A sustained period of growth has helped stabilise global debt levels (in some cases more than others, with China being the notable exception), visible economic excesses are reduced, labour markets have tightened and global inflation is starting to reflect this normalisation, with policymakers signaling tentative returns to more normal settings. For markets, the dual and concurrent risk is that either policy normalisation happens faster than current pricing suggests as inflation responds increasingly to strong growth and limited economic slack, or as this happens, growth falters owing to an increase in uncertainty.

DEVELOPED ECONOMIES AND CHINA: GLOBAL REAL GDP



Source: Datastream

The US leads the pack in terms of both growth acceleration and tighter monetary policy, but with the escalation in political tension it also becomes the epicentre of global growth risk. Fiscal stimulus passed by the Trump government in December 2017 has helped growth accelerate to an estimated 4.8% quarter on quarter (q/q) seasonally adjusted and annualised (saa) in the second quarter, according to the St. Louis Federal Reserve 'nowcast' model, and on average forecasts for the next two years have been revised higher. With the acceleration in GDP growth, unemployment has fallen to a multidecade low, at just 4.0%. Inflation has also started to rise and is at or close to the US Federal Reserve's (Fed) target by most measures, while wages have started to rise too, suggesting that in the US, the Phillips curve remains relevant. In response, the Fed's Open Market Committee raised the funds rate to 2.0% in June, as widely expected. The post-meeting communiqué showed a median rate forecast by members of another two hikes this year, and three in 2019.

After a disappointing first quarter, European activity indicators have picked up moderately. The euro area final composite Purchasing Managers' Index edged up to 54.9 in June, and German May factory orders and industrial production rebounded after a weak start to the second quarter. Unemployment in Europe has also fallen in aggregate and is low in Germany at 5%. Against this somewhat more constructive economic backdrop, European political risks have resurfaced. In early June, the formation of an Italian coalition government of the two main populist parties with a Eurosceptic common philosophy, La Liga and Five Star Movement, saw Italian yields spike and raised renewed concerns about Italy's fiscal viability. The appointment of Giuseppe Conte as prime minister calmed fears while the market awaits the submission of Italy's 2019 Budget to the European Commission, due by the middle of October. Angela Merkel also faced a homegrown crisis with her stance on migration. A compromise agreement was reached at EU level at the end of June. While both risks have retreated, general support for mainstream parties in both regions has waned. On balance, growth should still be above potential at 2.2% in 2018 and about 1.9% in 2019, supported by solid domestic demand, but with downside risk, mostly associated with looming trade and politics. The European Central Bank acknowledged these dynamics by signalling an end to its programme of quantitative easing in the fourth quarter, keeping rates on hold at current levels until next summer.

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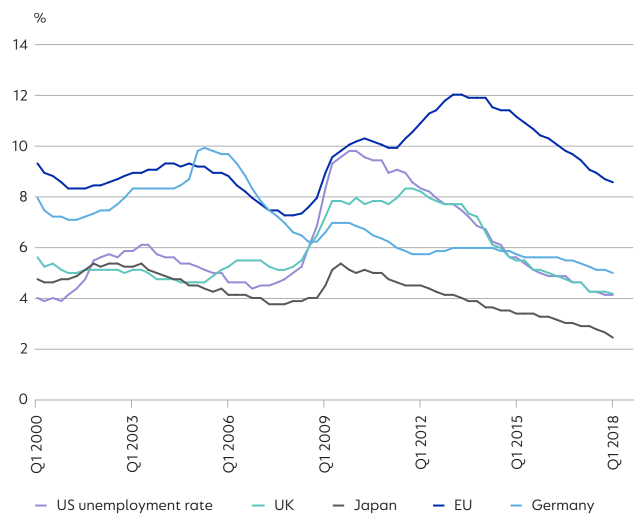
DEVELOPED MARKET UNEMPLOYMENT



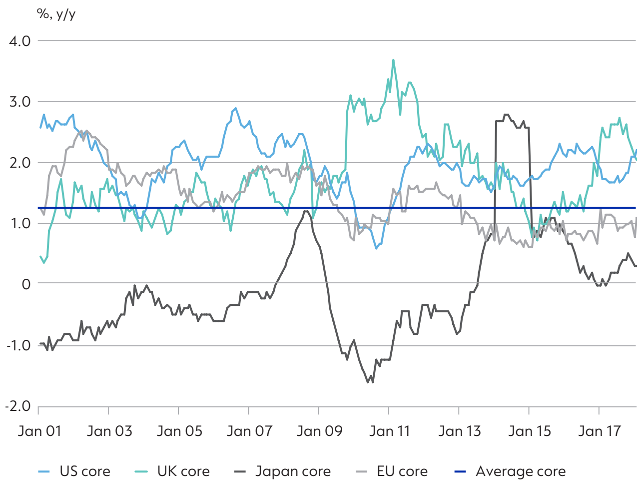
Source: Datastream

The UK continues a bumpy road to Brexit, with political upheaval weighing on economic activity. Prime minister Theresa May has faced ongoing internal and external challenges to the Brexit process, most recently with a series of resignations from members of her party. There are few completed milestones to point to which suggest progress is being made, and the risk of either a very strong compromise on Britain's part or a 'no deal' outcome is increasing as the March 2019 deadline approaches. Economic activity has returned to trend-like growth, with healthy growth in the services sector and a strong rebound in construction. A combination of the royal wedding, the hot summer and World Cup soccer is likely to have a lumpy influence on the data, with early numbers suggesting that services like restaurants have benefited at the expense of retail activity through the early summer. Unemployment in the UK has also fallen. With a currency- and fuel-induced surge in inflation (and despite longer-term growth deterioration), after a pause in May, the Bank of England is expected to continue to raise interest rates in August off the very low base in response. Thereafter, weaker growth data and moderating inflation should see the central bank on hold, as pressures from Brexit outweigh global cyclical influences.

In the East, growth in Japan has picked up after the cold weather of the first quarter affected output. Capex and construction in particular have recovered meaningfully, but consumption continues to lag. Here too the outlook is mixed: summer bonuses are set to increase to 4.2% from 3.9%, but heavy rains in western Japan may have a prolonged impact on production in the region. Inflation at headline level has picked up, fuelled by energy, but core inflation remains very low at just 0.7% in May and points to a central bank on hold at 0% for the foreseeable future.

Activity in China has held up well against the headwinds of tightening financial conditions. Policies implemented to moderate credit availability at 'shadow' institutions and through irregular structures, as well as efforts to improve credit quality, have seen a meaningful contraction in the credit impulse. Activity in most domestic sectors has slowed, led by property and broader domestic industrial sectors. Trade volumes have provided a helpful

CORE INFLATION IN DEVELOPED ECONOMIES



Source: Datastream

buffer and GDP in the second quarter is still 6.8%. However, the rise in trade protection and pending implementation of further measures, which are likely to see retaliation from the Chinese authorities, threaten the outlook for growth. Forecasters have started to make downward revisions to growth as they count the economic cost of the rise in trade tension.

The impact of these interconnected and at times opposing forces for emerging markets is difficult to disentangle. However, an increasingly dislocated global cycle is hard to manage and is likely to see risk assets suffer in uncertain markets. A steeper rise in developed market interest rates than currently priced by the markets, or an unexpected slowing in growth would be unhappy outcomes for commodity producers, especially those who run large recurring deficits. It is possible that president Trump's ultimate strategy is to win on his electoral promises and that compromises may be made, alleviating the current high level of tension. But from this vantage point it seems unlikely at this time and the consequences are already emerging. ✚

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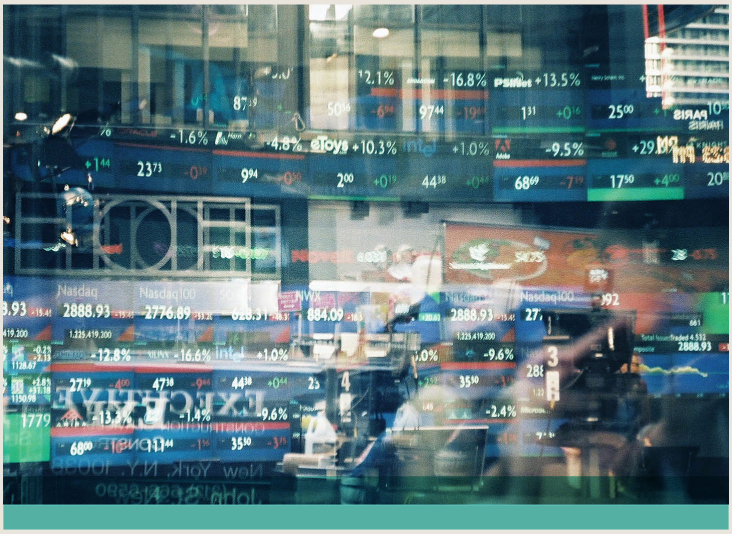
CORONATION INSIGHTS



South African flagship fund update

INVESTOR NEED: LONG-TERM GROWTH

Domestic general equity funds

PERFORMANCE FOR VARIOUS PERIODS

	Launch date	3 years	5 years	10 years	15 years	20 years
Top 20*	Oct 00	5.0%	9.5%	12.9%	19.0%	-
Equity[1]	Apr 96	4.9%	9.9%	12.2%	17.9%	14.9%
Average competitor		2.6%	7.9%	8.4%	15.3%	13.4%

The Coronation Top 20 fund is a concentrated portfolio of locally listed shares. The Coronation Equity Fund is a more diversified portfolio of locally listed shares, plus a concentrated portfolio of developed and emerging market shares. Performance is shown for the A classes of the funds. The average competitor return represents the median of the South Africa – Equity – General category, including the Coronation Funds in the category, and is sourced from Morningstar as at 30 June 2018.

Source: Morningstar

The FTSE/JSE Capped All Share Index returned 2.9% for the second quarter with a strong contribution from the resources sector (+20%). The industrial sector with its large rand hedge counters also rose during the period, ending up 4%. The domestic-heavy financials sector ended the quarter down 6.0%. The pressure on domestic stocks came about as the exuberance

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which had been priced into most domestic shares following the ANC's December elective conference was not supported by near-term results. We used this opportunity to add to better-quality domestic shares that are no longer priced for an optimistic outcome.

In the Equity Fund, a large weighting in global equities has boosted fund performance in the recent past. During the quarter, we added to Vivendi, which owns Universal Music Group (the largest of the three big global music labels). The fund continues to hold large positions in several of the JSE-listed offshore stocks.

The post-elective conference rally in domestic stocks provided an opportunity to take profits in certain domestic stocks and add to names including Naspers, British American Tobacco and Anheuser-Busch InBev (AB InBev). We also took the opportunity to add to our positions in the hospital stocks (Netcare and Life Healthcare) as well as food producers and retailers. We still have limited exposure to economically sensitive domestic companies because valuations do not yet offer a sufficient margin of safety, in our view.

The strong performance in resource stocks has been driven by robust pricing across most commodities. Anglo American and Northam Platinum remain our largest holdings, while Mondi and Sasol (a beneficiary of strong oil prices) were reduced on the back of strong performance.

Multi-asset class funds

PERFORMANCE FOR VARIOUS PERIODS

	Launch date	3 years	5 years	10 years	15 years	20 years
Balanced Plus*	Apr 96	5.4%	9.1%	11.2%	15.8%	13.2%
Market Plus[2]	Jul 01	5.8%	9.1%	12.0%	16.3%	-
Average competitor		4.6%	8.0%	8.4%	12.5%	11.6%

The Coronation Balanced Plus Fund represents our best investment view for long-term retirement savers and is managed according to the investment restrictions applicable to retirement funds. The Coronation Market Plus Fund represents our best investment view for long-term discretionary savers and as such can have more exposure to shares and foreign assets. Performance is shown for the A classes of the funds. The average competitor return represents the median of the South Africa – Asset Allocation – High Equity category, including the Coronation Fund in the category, and is sourced from Morningstar as at 30 June 2018.

Source: Morningstar

Both Balanced Plus and Market Plus performed well against their peer groups over all meaningful longer time periods. Recent performance was aided by limited exposure to fixed rate bonds, while our emerging market exposure detracted, as risk aversion saw the MSCI Emerging Markets Index declining by 8.0% for the period (+8.2% over a rolling 12 months). The funds reduced their weighting in global equities in the first half of the year, as valuations have become increasingly stretched and risks increasingly elevated (as a result of trade wars, economic populism and geopolitics).

As mentioned above, domestic stocks came under pressure following first-quarter euphoria post the ANC elective conference. We used this opportunity to take some profits in certain domestic stocks and added to others. The fund continues to hold large positions in several JSE-listed offshore stocks.

With the weakening of the rand and the sell-off in the bond market, precipitated by a flood of foreign-based selling, we once again see value in the local bond market. We have taken advantage of the sell-off to buy bonds, reducing our underweight position.

Global bond yields increased in response to the US hiking rates and an increasing aversion to risk. This vindicated the fund's low weight in fixed rate bonds (both offshore and locally). Foreign selling of South African government bonds drove sharply rising domestic yields (and negative returns, with the All Bond Index down 3.8% in the quarter). This offered an opportunity to build a position in government bonds at attractive levels. Although valuations reached attractive levels in the domestic market, this was not the case in global markets. In our view, yields are simply too low to justify the risk that comes with rising levels of indebtedness and an increasingly reckless disregard for fiscal discipline from many of the world's leading economies.

The property market declined 2% in the quarter. We continue to avoid most of the counters within the Resilient stable and find more value in the A property sector as well as blue-chip domestic names such as Growthpoint, Redefine and Investec Property Fund.

In the Market Plus Fund, the strength of the dollar added to the fund's returns given our overweight position. We have used this period of dollar strength to reduce this overweight position in favour of high-yielding government bonds from some emerging markets, including South Africa. We have also reduced the global equity position as developed equity markets have remained resilient in the face of what can be a very detrimental trade war.

INVESTOR NEED: INCOME AND GROWTH

Multi-asset class funds

PERFORMANCE FOR VARIOUS PERIODS

	Launch date	3 years	5 years	10 years	15 years
Capital Plus*	Jul 01	4.6%	7.1%	10.0%	12.3%
Balanced Defensive*	Feb 07	6.4%	8.1%	10.3%	-
Inflation		5.4%	5.5%	5.5%	5.7%

The Coronation Capital Plus Fund aims to provide a growing regular income over extended periods of time and up to 70% of its portfolio can be invested in growth assets (shares, listed property and commodities excl. gold). The Coronation Balanced Defensive Fund has the same aim, but is a more conservative fund, allowed a maximum of 50% exposure to growth assets. The funds are compared to inflation to reflect their absolute return focus. Inflation is measured as the Consumer Price Index, lagged by one month.

Sources: Morningstar, IRESS

Our absolute return portfolios have the dual mandate of beating inflation over time and protecting capital in the short term. The wild gyrations in the market during the quarter gave us the opportunity to make some meaningful changes to the composition of the funds. The rise in yields of government bonds to levels between 9% and 10%, depending on their duration, is particularly attractive to funds such as these. We added aggressively to our South African bond holdings and sold units in the Global Capital Plus Fund to enable us to do this. We also reduced the funds' cash holding to facilitate the bond buying.

Within the domestic equity portion of the funds, we trimmed our position in Mondi as this high-quality company's share now offers limited upside following its stellar performance. We added to Standard Bank, Naspers and Bidcorp, and acquired newly listed share Quilter ahead of its unbundling from Old Mutual.

Over the short term, the negative attitude to emerging markets may well persist for a while. However, the high real yields available in the bond market as well as the derating of many domestic shares to attractive levels make us more optimistic of reaching our inflation-linked mandates.

INVESTOR NEED: IMMEDIATE INCOME

Income fund

PERFORMANCE FOR VARIOUS PERIODS

	Launch date	3 years	5 years	10 years	15 years
Strategic Income*	Jul 01	8.6%	8.1%	9.5%	9.5%
Cash (STeFI3M)		6.9%	6.4%	6.6%	7.3%

The Coronation Strategic Income Fund aims to provide an alternative to cash or medium-term fixed deposits. Cash returns are measured using the STeFI 3-month index.

Sources: Morningstar, IRESS

Fixed rate negotiable certificates of deposit (NCDs) continue to hold appeal due to the inherent protection offered by their yields and relative to our expectations for the repo rate (flat, with a bias for a 25 basis points [bps] reduction). However, credit spreads remain in expensive territory (less than 100 bps in the three-year area and 130 bps in the five-year area). The fund continues to hold decent exposure to these instruments (less floating than fixed), but we will remain cautious and selective when increasing exposure. NCDs have the added benefit of being liquid, thus aligning the liquidity of the fund with the needs of its investors.

The fund maintains a healthy exposure to offshore assets, and when valuations are stretched, it will hedge/unhedge portions back into rands/dollars by selling/buying JSE-traded currency futures (US dollar, UK pound and euro). These instruments are used to adjust the fund's exposure synthetically, allowing it to maintain its core holdings in offshore assets.

At current levels, the yields on offer in the local bond market are attractive relative to their underlying fundamentals and warrant a neutral to overweight allocation. The fund has been using the recent widening in bond yields to increase its allocation to fixed rate government bonds and hence its modified duration (capital at risk due to bond yield movements).

The fund maintains holdings in property counters that offer strong distribution and income growth, with upside to their net asset value. In the event of a moderation in listed property valuations (which may be triggered by further risk asset or bond market weakness), we will look to increase the fund's exposure to this sector at more attractive levels.

It also maintains select exposure to certain high-quality corporate preference shares, but will not actively look to increase its holdings.

We remain vigilant of risks emanating from the dislocations between stretched valuations and the underlying fundamentals of the South African economy. However, we believe that the fund's current positioning correctly reflects appropriate levels of caution. We continue to invest only in assets and instruments that we believe have the correct risk and term premium to limit investor downside and enhance yield. ✚

[1] Highest annual return: 62.5% (Aug 2004 - Jul 2005); Lowest annual return: -28.7% (Mar 2008 - Feb 2009)

[2] Highest annual return: 50.0% (Aug 2004 - Jul 2005); Lowest annual return: -20.1% (Mar 2008 - Feb 2009)

* For highest and lowest annual return, refer to page 34.

Domestic flagship fund range

Coronation offers a range of domestic and international funds to cater for the majority of investor needs. These funds share the common Coronation DNA of a disciplined, long-term focused and valuation-based investment philosophy and our commitment to provide investment excellence.

INVESTOR NEED

	INCOME ONLY	INCOME AND GROWTH		LONG-TERM CAPITAL GROWTH	
FUND	**STRATEGIC INCOME** Cash†	**BALANCED DEFENSIVE** Inflation†	**CAPITAL PLUS** Inflation†	**BALANCED PLUS** Composite benchmark† (equities, bonds and cash)	**TOP 20** FTSE/JSE CAPI†
FUND DESCRIPTION	Conservative asset allocation across the yielding asset classes. Ideal for investors looking for an intelligent alternative to cash or bank deposits over periods from 12 to 36 months.	A lower risk alternative to Capital Plus for investors requiring a growing regular income. The fund holds fewer growth assets and more income assets than Capital Plus and has a risk budget that is in line with the typical income-and-growth portfolio.	Focused on providing a growing regular income. The fund has a higher risk budget than the typical income-and-growth fund, making it ideal for investors in retirement seeking to draw an income from their capital over an extended period of time.	Best investment view across all asset classes. Ideal for pre-retirement savers as it is managed in line with the investment restrictions that apply to pension funds. If you are not saving within a retirement vehicle, consider Market Plus, the unconstrained version of this mandate.	A concentrated portfolio of 15-20 shares selected from the entire JSE, compared to the average equity fund holding 40-60 shares. The fund requires a longer investment time horizon and is an ideal building block for investors who wish to blend their equity exposure across a number of funds. Investors who prefer to own just one equity fund may consider the more broadly diversified Coronation Equity Fund.
INCOME VS GROWTH ASSETS[1] ● INCOME ● GROWTH	92.7% 7.3%	60.3% 39.7%	40.4% 59.6%	19.0% 81.0%	0.1% 99.9%
LAUNCH DATE	Jul 2001	Feb 2007	Jul 2001	Apr 1996	Oct 2000
ANNUAL RETURN[2] (Since launch)	10.4% 7.8%†	9.8% 6.2%†	12.3% 6.0%†	14.8% 13.4%†	18.3% 14.3%†
QUARTILE RANK (Since launch)	1st	1st	1st	1st	1st
ANNUAL RETURN (Last 10 years)	9.5% 6.6%†	10.3% 5.5%†	10.0% 5.5%†	11.3% 10.7%†	12.9% 9.0%†
STANDARD DEVIATION (Last 10 years)	1.7% 0.5%†	4.2% 1.5%†	5.8% 1.5%†	8.8% 9.2%†	14.4% 15.5%†
FUND HIGHLIGHTS	Outperformed cash by 1.7% p.a. over the past 5 years and 2.6% p.a. since launch in 2001.	Outperformed inflation by 3.7% p.a. (after fees) since launch, while producing positive returns over all 12-month periods.	Outperformed inflation by 6.3% p.a. (after fees) since launch, while producing positive returns over 24 months more than 99% of the time.	No. 1 balanced fund in South Africa since launch in 1996, outperforming its average competitor by 2.4% p.a. Outperformed inflation by on average 8.4% p.a. since launch and outperformed the ALSI on average by 1.1% p.a.	The fund added 4% p.a. to the return of the market. This means R100 000 invested in Top 20 at launch in Oct 2000 grew to more than R1.9 million by end-June 2018 – nearly double the value of its current benchmark. The fund is a top quartile performer since launch.

[1] *Income versus growth assets as at 30 June 2018. Growth assets defined as equities, listed property and commodities (excluding gold).*

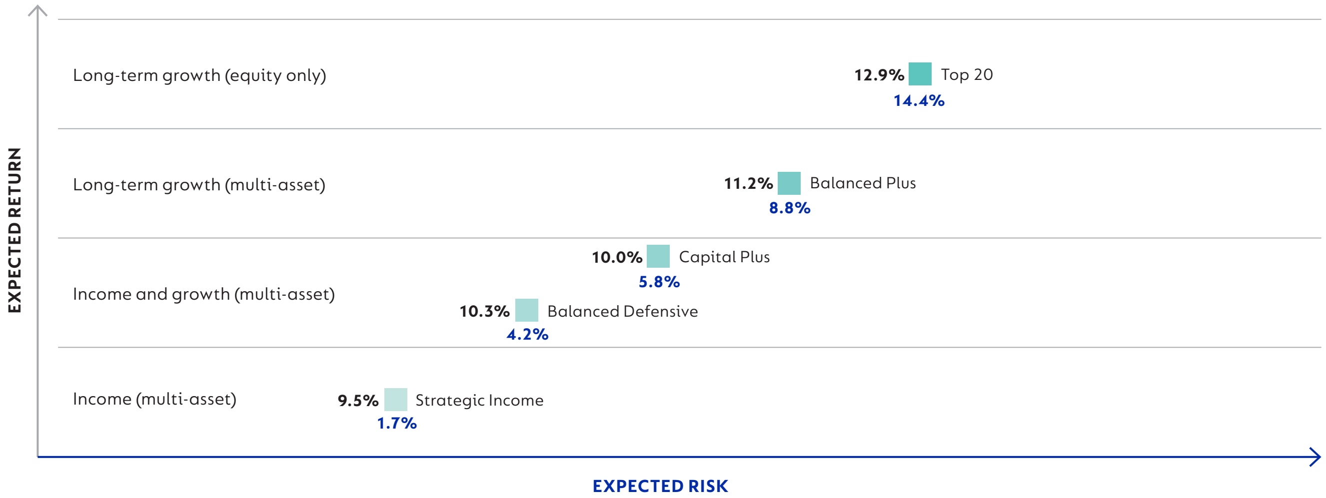
[2] *Highest annual return*
Strategic Income: 18.7% (Nov 2002 – Oct 2003); Coronation Balanced Defensive: 21.2% (Jun 2012 – May 2013); Coronation Capital Plus: 33.8% (Aug 2004 – Jul 2005); Coronation Balanced Plus: 49.3% (Aug 2004 – Jul 2005); Coronation Top 20: 68.9% (May 2005 – Apr 2006)

Lowest annual return
Strategic Income: 2.6% (Jun 2007 – May 2008); Balanced Defensive: 2.0% (Mar 2008 – Feb 2009); Capital Plus: - 6.2% (Nov 2007 – Oct 2008); Balanced Plus: -17.4% (Sep 1997 – Aug 1998); Top 20: -31.7% (May 2002 – Apr 2003)

Figures are quoted from Morningstar as at 30 June 2018 for a lump sum investment and are calculated on a NAV-NAV basis with income distributions reinvested.

RISK VERSUS RETURN

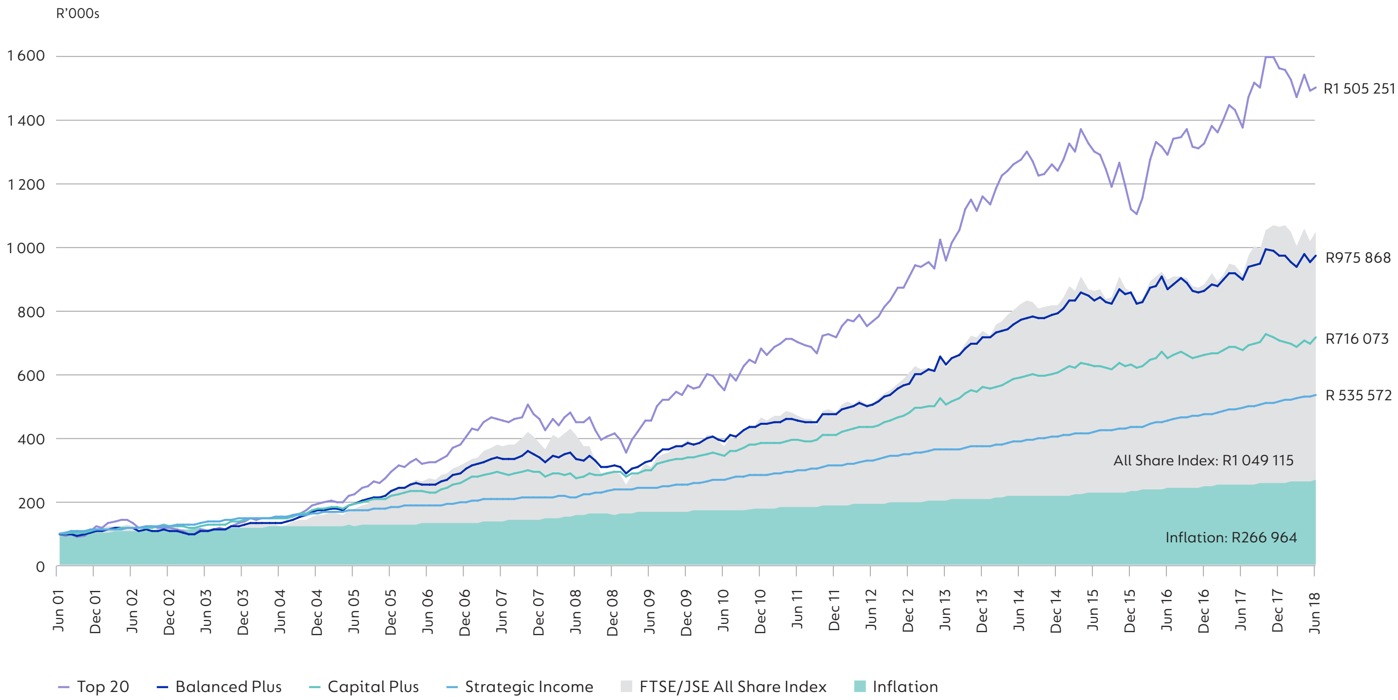
10-year annualised return and risk (standard deviation) quoted as at 30 June 2018.
Figures quoted in ZAR after all income reinvested and all costs deducted.



Source: Morningstar

GROWTH OF R100 000 INVESTED IN OUR DOMESTIC FLAGSHIP FUNDS ON 1 JULY 2001

Value of R100 000 invested in Coronation's domestic flagship funds since inception of Capital Plus on 1 July 2001 as at 30 June 2018. All income reinvested for funds; FTSE/JSE All Share Index is on a total return basis. Balanced Defensive is excluded as it was only launched on 2 February 2007.



Source: Morningstar

International flagship fund range

INVESTOR NEED

	DEPOSIT ALTERNATIVE	CAPITAL PRESERVATION	LONG-TERM CAPITAL GROWTH (MULTI-ASSET)	LONG-TERM CAPITAL GROWTH (EQUITY ONLY)	
FUND[1]	**GLOBAL STRATEGIC USD INCOME [ZAR] FEEDER** **GLOBAL STRATEGIC USD INCOME** US dollar cash (3 Month Libor)†	**GLOBAL CAPITAL PLUS [ZAR] FEEDER** **GLOBAL CAPITAL PLUS [FOREIGN CURRENCY]**[4] US dollar cash (3 Month Libor)†	**GLOBAL MANAGED [ZAR] FEEDER** **GLOBAL MANAGED [USD]** Composite (equities and bonds)†	**GLOBAL OPPORTUNITIES EQUITY [ZAR] FEEDER** **GLOBAL OPPORTUNITIES EQUITY [USD]** MSCI ACWI†	**GLOBAL EMERGING MARKETS FLEXIBLE [ZAR]** **GLOBAL EMERGING MARKETS [USD]** MSCI Emerging Markets Index†
FUND DESCRIPTION	An intelligent alternative to dollar-denominated bank deposits over periods of 12 months or longer.	A low-risk global balanced fund reflecting our best long-term global investment view moderated for investors with smaller risk budgets. We offer both hedged and houseview currency classes of this fund. In the case of the former, the fund aims to preserve capital in the class currency over any 12-month period.	A global balanced fund reflecting our best long-term global investment view for investors seeking to evaluate outcomes in hard currency terms. Will invest in different asset classes and geographies, with a bias towards growth assets in general and equities in particular.	A diversified portfolio of the best global equity managers (typically 6-10) who share our investment philosophy. An ideal fund for investors who prefer to own just one global equity fund. Investors who want to blend their international equity exposure may consider Coronation Global Equity Select, which has more concentrated exposure to our best global investment views.	Our top stock picks from companies providing exposure to emerging markets. The US dollar fund remains fully invested in equities at all times, while the rand fund will reduce equity exposure when we struggle to find value.
INCOME VS GROWTH ASSETS[2] ● INCOME ● GROWTH	96.0% 4.0%	61.3% 38.7%	31.2% 68.8%	0.3% 99.7%	0.6% 99.4%
LAUNCH DATE OF OLDEST FUND	Dec 2011	Nov 2008	Oct 2009	Aug 1997	Dec 2007
ANNUAL RETURN[3] (Since launch)	2.4% 0.7%†	5.2% 0.6%†	6.6% 6.8%†	7.0% 6.0%†	2.7% 1.2%†
QUARTILE RANK (Since launch)	-	1st	1st	1st	1st
ANNUAL RETURN[3] (Last 5 years)	1.6% 0.8%	2.4% 0.8%	4.9% 6.7%	8.6% 10.3%	2.1% 5.2%
ANNUAL RETURN[3] (Last 10 years)				6.4% 6.7%	3.5% 2.5%
QUARTILE RANK (Last 5 years)	–	2nd	2nd	1st	4th
FUND HIGHLIGHTS	Outperformed US dollar cash by 1.8% p.a (after fees) since launch in December 2011.	Outperformed US dollar cash by 4.5% p.a. (after fees) since launch in 2008.	Number one global multi-asset high equity fund in South Africa since launch in October 2009.	Both the rand and dollar versions of the fund have outperformed the global equity market with less risk since their respective launch dates.	Both the rand and dollar versions of the fund have outperformed the MSCI Emerging Markets Index by more than 1.6% p.a. since their respective launch dates.

1 *Rand- and US dollar-denominated fund names are included for reference.*

2 *Income versus growth assets as at 30 June 2018 (for US dollar funds). Growth assets defined as equities, listed property and commodities (excluding gold).*

3 *Returns quoted in US dollar for the oldest fund.*

Highest annual return
Global Strategic USD Income: 7.1% (Jan 2012 – Dec 2012); Global Capital Plus [ZAR] Feeder: 34.8% (Jun 2012 – May 2013); Global Managed [ZAR] Feeder: 48.9% (Jan 2013 – Dec 2013); Global Emerging Markets Flexible [ZAR]: 49.7% (Mar 2009 – Feb 2010); Global Opportunities Equity [ZAR] Feeder: 66.2% (Apr 1999 – Mar 2000)

Lowest annual return
Global Strategic USD Income: -1.0% (Mar 2015 – Feb 2016); Global Capital Plus [ZAR] Feeder: -10.6% (Jun 2016 – May 2017); Global Managed [ZAR] Feeder: -7.7% (Apr 2017 – Mar 2018); Global Emerging Markets Flexible [ZAR]: -37.5% (Mar 2008 – Feb 2009); Global Opportunities Equity [ZAR] Feeder: -36.1% (Oct 2002 – Sep 2003)

4 *Available in US dollar Hedged (launched 1 December 2011), GBP Hedged (launched 1 December 2011), EUR Hedged (launched 1 December 2011) or Houseview currency class (launched 1 September 2009).*

Figures are quoted from Morningstar as at 30 June 2018 for a lump sum investment and are calculated on a NAV-NAV basis with income distributions reinvested.

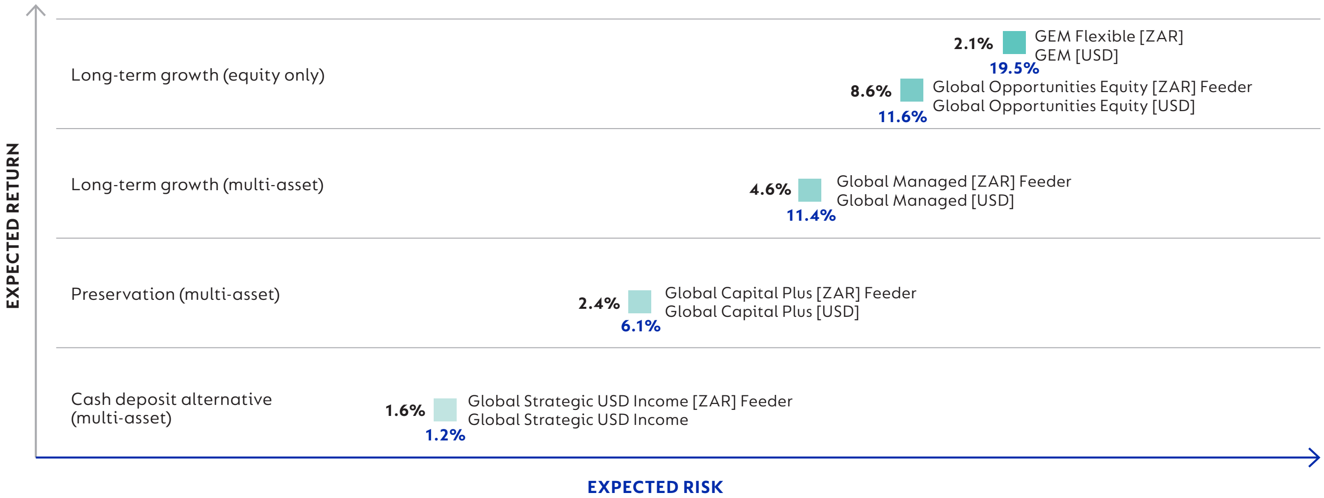
HAVE YOU CONSIDERED EXTERNALISING RANDS? IT IS EASIER THAN YOU MIGHT THINK.

The South African Reserve Bank allows each resident South African taxpayer to externalise funds of up to R11 million per calendar year (a R10 million foreign capital allowance and a R1 million single discretionary allowance) for direct offshore investment in foreign currency denominated assets. If you want to invest more than R1 million, the process is as easy as:

1. Obtain approval from the South African Revenue Service by completing the appropriate form available via eFiling or your local tax office. Approvals are valid for 12 months and relatively easy to obtain if you are a taxpayer in good standing.
2. Pick the mandate that is appropriate to your needs from the range of funds listed here. You may find the 'Choosing a Fund' section or 'Compare Funds' tool on our website helpful, or you may want to consult your financial advisor if you need advice.
3. Complete the relevant application forms and do a swift transfer to our US dollar subscription account. Your banker or a foreign exchange currency provider can assist with the forex transaction, while you can phone us on 0800 86 96 42, or read the FAQ on our website, at any time if you are uncertain.

RISK VERSUS RETURN

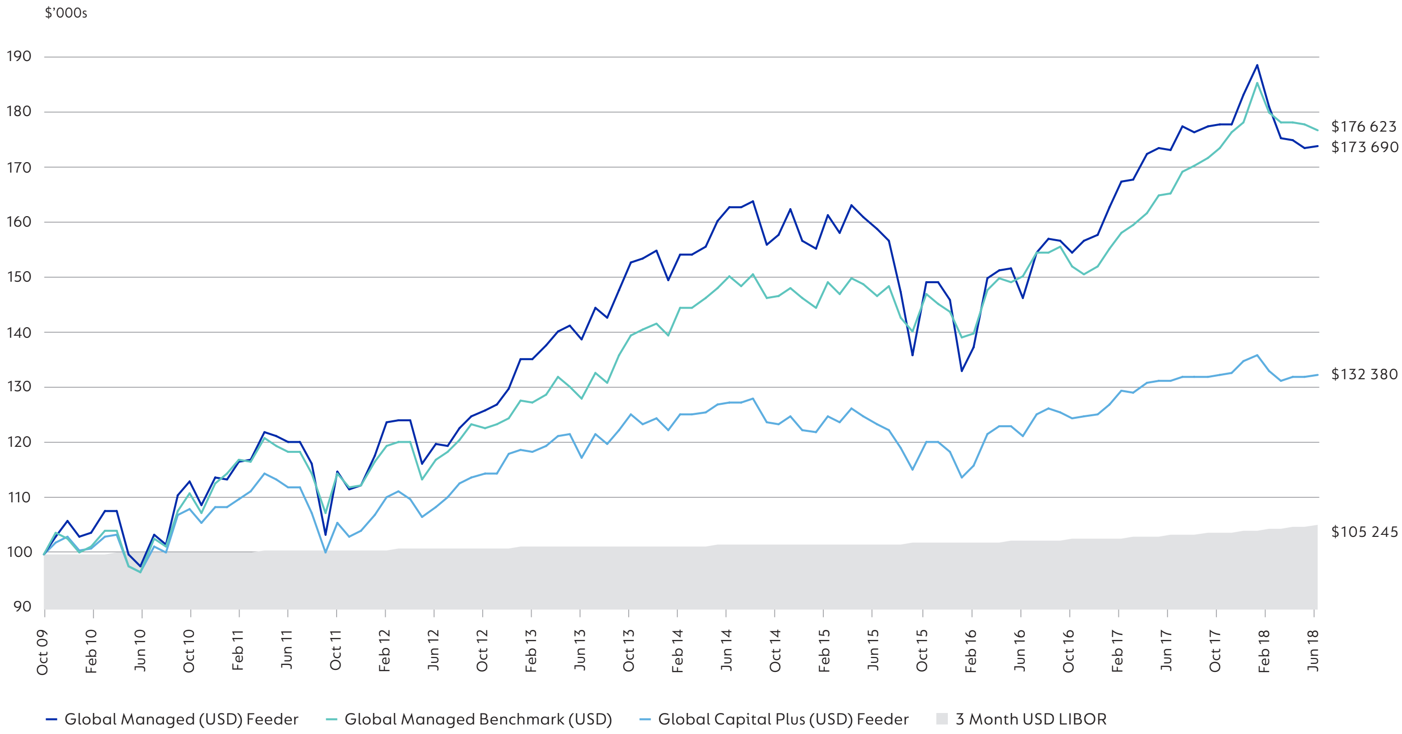
5-year annualised return and risk (standard deviation) quoted as at 30 June 2018. Figures quoted in USD (for the oldest fund) after all income reinvested and all costs deducted.



Source: Morningstar

GROWTH OF $100 000 INVESTED IN OUR GLOBAL MULTI-ASSET FUNDS ON 29 OCTOBER 2009

Value of $100 000 invested in Global Managed [ZAR] Feeder and Global Capital Plus [ZAR] Feeder since inception of Global Managed [ZAR] Feeder on 29 October 2009. All returns quoted in USD. All income reinvested for funds. MSCI World Index is on a total return basis.



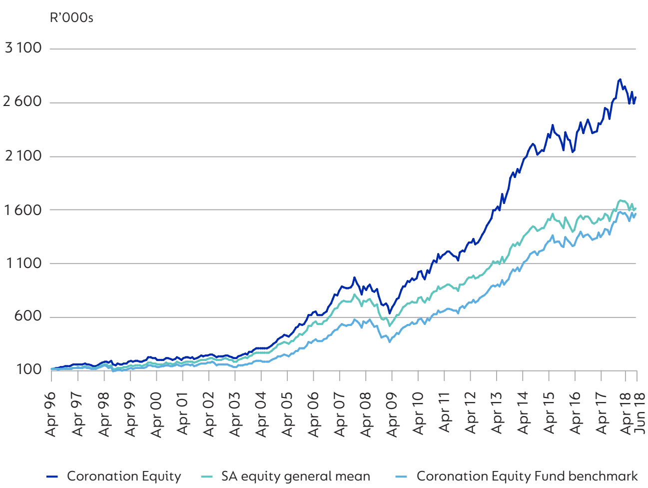
Source: Morningstar

Long-term investment track record

CORONATION EQUITY RETURNS VS EQUITY BENCHMARK

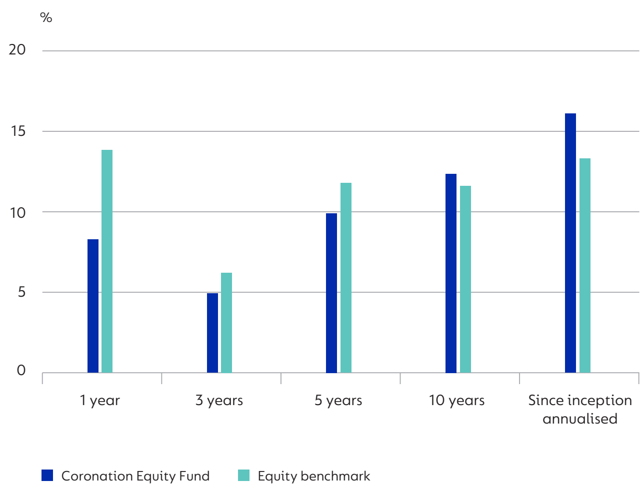
5-YEAR ANNUALISED RETURNS	CORONATION EQUITY	EQUITY BENCHMARK	ALPHA
2000	15.66%	6.17%	9.49%
2001	12.37%	9.38%	2.99%
2002	12.15%	7.14%	5.01%
2003	14.63%	13.49%	1.14%
2004	13.82%	10.46%	3.36%
2005	23.32%	19.44%	3.88%
2006	26.84%	23.91%	2.93%
2007	31.53%	30.40%	1.12%
2008	20.70%	20.09%	0.60%
2009	19.31%	19.37%	(0.06%)
2010	15.97%	15.12%	0.85%
2011	9.83%	8.65%	1.18%
2012	11.54%	10.60%	0.94%
2013	22.51%	20.60%	1.91%
2014	17.58%	17.78%	(0.20%)
2015	13.76%	14.72%	(0.96%)
2016	14.11%	14.44%	(0.33%)
2017	12.45%	12.29%	0.16%
4 years 6 months to 30 June 2018	6.70%	8.97%	(2.27%)
ANNUALISED TO 30 JUNE 2018			
1 year	8.20%	13.65%	(5.45%)
3 years	4.91%	6.11%	(1.20%)
5 years	9.86%	11.67%	(1.80%)
10 years	12.24%	11.45%	0.79%
Since inception in October 1993 annualised	15.94%	13.18%	2.76%
Average outperformance per 5-year return			1.67%
Number of 5-year periods outperformed			14.00
Number of 5-year periods underperformed			5.00

CUMULATIVE PERFORMANCE



Source: Morningstar

ANNUALISED RETURNS TO 30 JUNE 2018



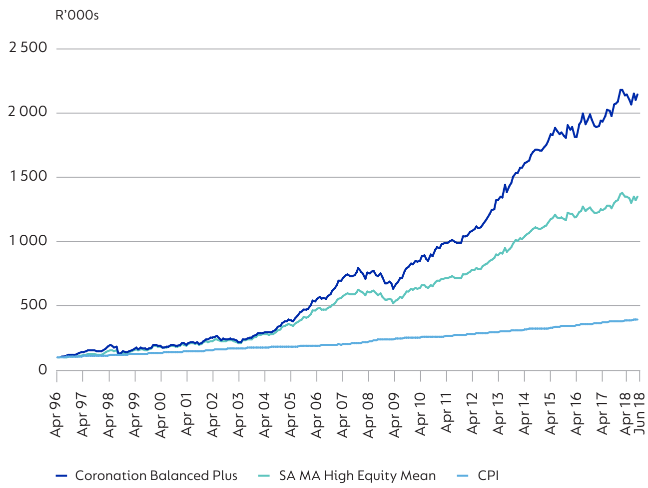
Source: Morningstar

An investment of R100 000 in Coronation Equity on 15 April 1996 would have grown to **R2 651 883** by 30 June 2018. By comparison, the returns generated by the fund's benchmark over the same period would have grown a similar investment to **R1 554 613**, while the average competitor would have grown a similar investment to **R1 609 143** .

CORONATION BALANCED PLUS FUND VS INFLATION AND AVERAGE COMPETITOR*

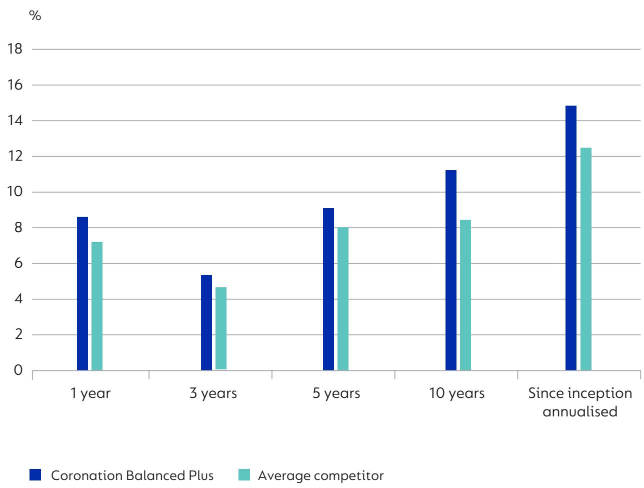
5-YEAR ANNUALISED RETURNS	CORONATION BALANCED PLUS	INFLATION	REAL RETURN
2000	16.00%	7.90%	8.10%
2001	14.38%	7.41%	6.97%
2002	10.73%	8.04%	2.69%
2003	14.68%	7.33%	7.35%
2004	13.82%	6.68%	7.14%
2005	20.53%	5.85%	14.68%
2006	22.43%	5.54%	16.89%
2007	25.35%	5.17%	20.18%
2008	19.28%	6.41%	12.87%
2009	17.60%	6.82%	10.77%
2010	13.97%	6.71%	7.26%
2011	9.49%	6.94%	2.55%
2012	10.81%	6.36%	4.45%
2013	17.98%	5.39%	12.58%
2014	15.57%	5.19%	10.38%
2015	14.05%	5.54%	8.51%
2016	12.69%	5.67%	7.02%
2017	11.27%	5.48%	5.79%
4 years 6 months to 30 June 2018	7.09%	5.58%	1.52%
ANNUALISED TO 30 JUNE 2018	**CORONATION BALANCED PLUS**	**AVERAGE COMPETITOR**	**ALPHA**
1 year	8.59%	7.18%	1.41%
3 years	5.36%	4.62%	0.74%
5 years	9.11%	8.00%	1.11%
10 years	11.25%	8.44%	2.81%
Since inception in April 1996 annualised	14.83%	12.45%	2.38%
Average 5-year real return			8.83%
Number of 5-year periods where the real return is >10%			7.00
Number of 5-year periods where the real return is 5% - 10%			8.00
Number of 5-year periods where the real return is 0% - 5%			4.00

CUMULATIVE PERFORMANCE



Source: Morningstar

ANNUALISED RETURNS TO 30 JUNE 2018



Source: Morningstar

An investment of R100 000 in Coronation Balanced Plus on 15 April 1996 would have grown to **R2 143 134** by 30 June 2018. By comparison, the South African multi-asset high-equity sector over the same period would have grown a similar investment to **R1 347 695**.

* *Median of Peer Group is the median of the fully-discretionary retirement portfolios of the largest managers as published in performance surveys and calculated by Coronation Fund Managers.*

The day doubters became believers.
In the last 25 years, we've experienced good days, bad days and incredible days like when the world heard our vuvuzelas roar. Through it all, the highs and the lows, Coronation's purpose has remained the same. Working day in, day out, to earn your trust and make your money work for you.
CORONATION
TRUST IS EARNED™
To invest your money today, speak to your Financial Adviser or visit coronation.com.
Coronation is an authorised financial services provider and approved manager of collective investment schemes. Trust is Earned™.