corospondent

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CORONATION
FUND MANAGERS
TRUST IS EARNED

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Notes from my inbox

***'My friends, as I have discovered myself, there are no disasters, only opportunities. And, indeed, opportunities for fresh disasters.'* – Boris Johnson**

by **PIETER KOEKEMOER**

***PIETER KOEKEMOER** 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.*

Britain's vote to leave the EU, which was not anticipated by financial markets, was the defining event of the past quarter. While it will take time for the uncertainties raised by Brexit to be settled, the market tends to shoot first and ask questions later. Inevitably, the initial response to the event included a derating of the assets most likely to be impacted by the UK's probable loss of access to the common market area and a knee-jerk flight to the perceived safety of government bonds. Incredibly, this search for safe havens has led to a further increase in government debt with a negative yield, which now amounts to $11.7 trillion.

We expect the markets to remain unsettled for some time because Brexit happened against the backdrop of low and slowing global growth. As always, our focus remains on the long term and on identifying investments that are trading at a discount to their long-term business value. Unsettled markets create more of these opportunities, which should over time aid us in delivering long-term outperformance in your funds. We certainly do not believe investors will achieve compelling returns by slavishly following erratic market sentiment.

Marking 20 years of delivery

We reached a major milestone during the quarter, with the 20th anniversary of the launch dates of our first two funds, Coronation Equity and Balanced Plus. Both funds have added significant value over this period. You can read more about the experiences of investors who have been with us for most of this time on page 14. Our belief in a team-based approach to investing was a significant contributor to the good outcomes that these funds have delivered over time. We have always avoided the creation of specialist silos where investment decisions are made in a vacuum. Our entire investment team of more than 60 individuals – covering the South African, Global Emerging, Global Developed and Frontier markets – sit together in an open-plan office. They are constantly interacting and exchanging investment information.

Also, our analysts and fund managers are each allocated a wide range of research responsibilities, across different industries and countries. Our investment professionals can price profit and risk across asset classes, sectors and geographies. We believe this broader perspective builds better investors, drives better debate and results in better investment decisions. Our team-based and generalist approach has contributed to the stability of our investment process. With analysts covering a wide range of companies in different sectors, there are no gaps in research coverage in the event of occasional departures from the team. We believe this commitment to sustainability will contribute to the delivery of continuing superior investment results in the decades to come.

In this edition

This issue of *Corospondent* offers extensive analysis of how the recent political events have impacted the markets. On page 4, our economist Marie Antelme explains the larger implications of Brexit, while Neville Chester provides more on the immediate market repercussions (page 6). Pallavi Ambekar details our investment case for MTN, which is showing signs of recovery after a tough period, on page 8, while Iakovos Mekios gives our assessment of the Mexican investment landscape (page 28) following a recent visit. Also in this edition, Greg Longe discusses the prospects of Nigeria (page 31), which is suffering from chronic balance of payment problems, and Steven Barber examines the long-term prospects of a global pharmacy giant (page 25).

We hope you enjoy the read.

Brexit: The economic and political impact

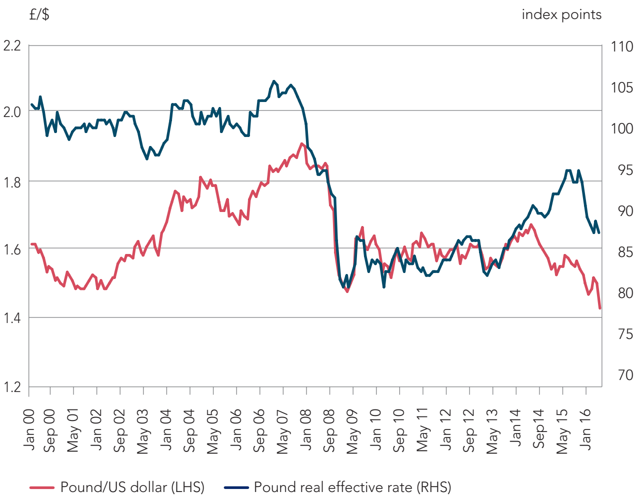
Untangling the spider's web.

by **MARIE ANTELME**

MARIE ANTELME is an economist in the fixed interest team. Marie joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

The UK referendum vote was a shock to politicians, markets and much of the populace. Poll data in the run-up to the referendum showed growing support for the leave campaign but it seemed that markets, and indeed most people, thought the rational outcome was to remain. The early repercussions of the vote were dramatic: the pound saw its largest drop ever in intraday trade, the FTSE 100 initially tumbled almost 9%, and both European and emerging market assets responded negatively.

POUND EXCHANGE RATE



Sources: Coronation, Datastream

The referendum outcome certainly raises more questions than it answers. It has injected a new measure of complexity into the current global political environment and economic outlook, which remain inextricably interlinked.

The first observation to make is that the international political environment has changed dramatically since the end of the global financial crisis (GFC). There has been growing support for political parties on the extremes of the political spectrum. In Europe, Marine Le Pen's National Front has gained ground in France, while support for both right-wing and left-wing groups in Spain has grown meaningfully, and increased polarisation was also seen during the municipal elections in Italy. Hungary voted for the conservative Fidesz in 2010 and, more recently, Poland backed the right-wing national-conservative PiS. (Donald Trump's bid to become the US president is arguably also part of this trend.)

These political parties' main platforms are less about advocating specific policy actions, and generally more focused on either a particular social philosophy, or specific groups in society. The increased attraction of this kind of politics seems to reflect a social climate of dissatisfaction, with roots in the weak economic recovery post-GFC. For many households the crisis had a material impact on incomes and wealth. The recovery in Europe has been the most uneven, and arguably remains the most fragile. Many households are still worse off than they were before, and the promises made by the moderate politicians and the policymakers, who supported and implemented moderate policies, were not met. This fuelled the appeal of parties or policies which reject the status quo. The example of the UK's leave campaign reflects this unhappy reality most clearly. Voters who chose to exit had no real understanding of what they voted for (and given the immediate resignations of the senior leave campaigners it appears they had no idea either). It was more a vote of unhappiness with the status quo than a decision that leaving will deliver specific benefits.

The popular response following the vote suggests that many simply did not fully understand the potential repercussions of their vote. The calls by other parties in the EU for referendums in their own countries could yield similar risks. A precedent has been set by citizens being able to opt out of the EU through a referendum (with the debate often fuelled by spurious claims and misinformation). This is very negative for the future of the EU. While no other moderate EU government is likely to make the mistake of calling for a similar referendum, any election will now become a proxy for this type of referendum, with the fringe parties campaigning vigorously on the exit card.

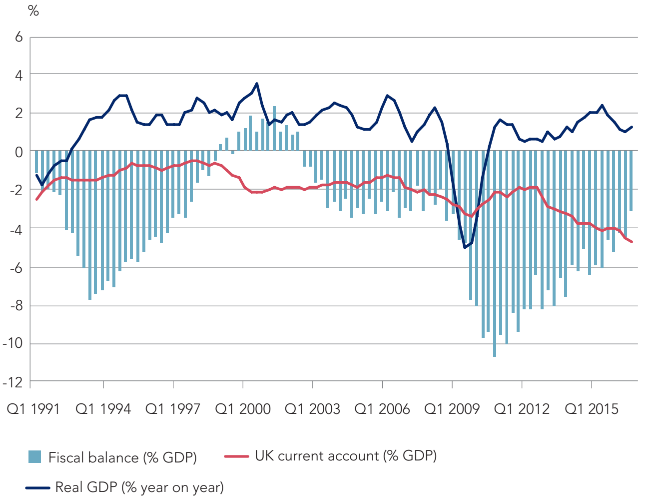
There are a number of important elections looming in other large economies – the US (8 November 2016), France (April/May 2017), Germany (October 2017) – which are now also much more uncertain, and perhaps also much more vulnerable to more extreme political outcomes than before.

While markets will take a dim view of a move towards isolation and reversing the benefits of global free trade, they hate uncertainty even more. In a fragile world, the shock of the Brexit vote result has created further uncertainty over the outlook for global growth. Yields on the ten-year US government bond fell dramatically after the Brexit result, indicating a flight to safety and a concern that global growth will remain weak as companies withhold investment and consumers withhold spending while the details of what Brexit means are finally ironed out.

Growth in the UK is expected to slow, and may contract next year, depending on how long political uncertainty continues and how EU negotiations evolve. Growth momentum is already moderating and the UK has large twin deficits, with the fiscal balance -4.4% in 2015, and the current account -6.8% in the first quarter of 2016. General expectations are for real GDP growth of about 1.3% in 2016 and just 0.5% in 2017. The impact on confidence and investment is expected to be more significant than the immediate impact on trade, but unemployment may also increase, and a weaker pound implies higher inflation than would have been the case otherwise. Taken together, this is not good news for UK consumers, and consumer spending is expected to be materially weaker.

European growth and policy expectations have also been affected by the referendum vote, but the most immediate risk is that the continent's fragile recovery is also derailed by uncertainty. Much will depend on whether the EU moves towards greater integration or disintegration over the longer term. The biggest initial impact will likely be on investment, with trade less vulnerable in the short term. The European Central Bank is also expected to remain a visible and responsive support for growth and will likely extend its current quantitative easing programme beyond March 2017, if necessary.

UK TWIN DEFICITS UNDER PRESSURE



Sources: Coronation, Datastream

It is hard to disentangle the spider's web of interconnected issues and potential repercussions of the UK referendum vote, especially in a world where economic growth is fragile, and politics increasingly uncertain, and extreme. The end game for the UK and Europe may not be all bad, but a lot depends, first, on the internal political outcomes in the UK and then on the timing and manner in which negotiations between Britain and the EU evolve. The speed with which the Conservative Party has nominated a new prime minister is the first vaguely positive sign emanating from the vacuum that followed the referendum. The political credentials of Theresa May have brought some stability to the market amid the expectation that a better result will be achieved in negotiations with the EU than if one of the exit campaigners led the country. In time, new trade relations and a greater degree of flexibility over policy setting may prove beneficial for the UK. For Europe, the stark warning of strong member dissatisfaction may spur reform from Brussels that leads to greater integration and reform which they have failed to implement in the period following the global financial crisis. If Europe fails to respond to this warning it is likely to see more discontent brewing among the weaker member states and ultimately more pressure to leave, precipitating in the break-up of the EU. This would have major economic consequences for the world, on a scale far greater than Brexit.

Brexit: The investment implications

Opportunity amid turmoil.

by **NEVILLE CHESTER**

__NEVILLE CHESTER__ is a senior portfolio manager responsible for the management of aggressive equity portfolios and the Coronation Market Plus Fund. He also co-manages the Coronation Top 20 Fund.

The consensus sentiment globally was that the UK would not vote to exit the EU, given the jump into the unknown this would represent. Therefore the world was surprised to wake on 24 June to the shock of the UK electorate doing just that. The moves in currencies and equity markets were immediate and brutal. The performance of safe haven assets such as precious commodities as well as US and Swiss government bonds was also immediately boosted as investors scurried for perceived safety in the light of this great jump into the unknown.

As referred to in the previous article, we were as surprised by the outcome of the referendum as most other market participants. This did not mean that the ensuing volatility in markets did not present a potential opportunity for clients. As always, the most important step was to remain calm and unemotional, assess the likely impact and then identify assets inevitably being mispriced in the panic that follows unexpected events.

At Coronation, we benefit from a team of over 60 investment professionals. We have detailed models on all the companies and instruments we hold, so we were able to immediately isolate all parts of the companies that would have potential exposure to the fallout from Brexit. We ran various scenarios to see what the overall impact on valuations would be. We could then compare this to the moves in the market and take opportunities to invest where there was a clear discrepancy between what the market was pricing and what the actual impact would end up being. To be clear, this is not a simple process of buying the assets that have fallen the most; the end outcome for the UK and Europe is not clear and risks in certain valuations have increased.

An example of our approach was illustrated by our holdings in two large listed property companies in the UK. Intu and Capco, which are dual-listed in SA, fell 26% and 35% respectively in the days following the referendum. We bought a lot of Intu as we are very comfortable with its forecast for expected rental income, given the defensive nature of its shopping centre portfolio, which is predominantly based in regions which will be unaffected by the Brexit vote. We also do not believe that credit markets will freeze like they did following the global financial crisis, and expect that capitalisation rates will remain fairly stable as the Bank of England is likely to cut interest rates further. With Capco we have been more circumspect. While half of its valuation is represented by the retail-focused Covent Garden (which should do even better given increased tourism from the weaker pound), the other half of its valuation is far more speculative, influenced by the demand and pricing levels for residential property in the City of London, which is likely to feel the pain of Brexit more keenly.

We have increased our holdings in two other dual-listed counters significantly following the referendum. Old Mutual fell sharply in line with many other UK insurers, despite the fact that the majority of its operations are domiciled outside the UK. The company is in the process of unbundling its core components and re-domiciling most of these assets back in SA. We do not expect the UK operations of Old Mutual to be that affected by Brexit, given that it is a UK wealth business serving predominantly UK citizens. As roughly 25% of the Old Mutual valuation is UK-based, we would have expected at most a 2.5% decline in its value with the 10% fall in the pound. Instead the share fell 14%, clearly an over-reaction.

Mondi has virtually no operations in the UK; all its operations are domiciled in Western and Eastern Europe and SA. Other than some potential spill-over from weaker European growth into demand for its packaging products there should be no impact at all from Brexit on its business. The slightly weaker euro will actually benefit Mondi's export business. Despite this, Mondi's share price fell 10% following the referendum, presenting a clear opportunity.

A number of other companies with very little or no UK exposure also fell on the day as a result of general risk sentiment. Anglo American, MTN and Steinhoff all fell between 10% and 12%, presenting good buying opportunities as these businesses' fundamental values were entirely unaffected by the Brexit decision and their share prices merely reflected investor panic.

In the flight to safety, some of our other holdings have performed extremely well amid the panic. Our holding in British American Tobacco and our platinum shares were the big beneficiaries of money moving into safe havens. To the extent that the market has priced in a lot of good news here, we reduced some of these holdings to fund new investment ideas.

Markets are full of uncertainty. Unusual events will play out time and time again, often in an unpredictable fashion. As managers of long-term capital, our key strength is having the knowledge and depth of analysis to be able to take calm and rational decisions, often against the sentiment of the day. In times like these, some of the best investment decisions are made.

MTN

Darkest before the dawn.

by **PALLAVI AMBEKAR**

__PALLAVI AMBEKAR__ is a portfolio manager within the SA investment team. She co-manages institutional portfolios within Coronation's aggressive equity portfolio range and analyses shares within the telecommunications, consumer goods, retail, and hotel and leisure sectors. Pallavi joined Coronation in 2003.

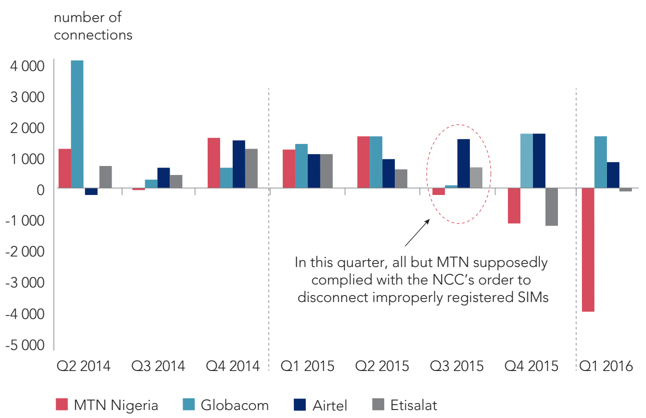
The last year has been a dramatic one for MTN. After more than a decade of growing to become the largest mobile operator in Africa and the Middle East, the company found itself facing a multitude of headwinds. The deteriorating economic environment in key markets such as SA and Nigeria started putting pressure on its organic growth. Also, the business had not invested adequately in its network and was slow to recognise the global trend in mobile usage away from voice and towards data. As a result, the company was losing market share to more agile competitors who had better network capacity. And then, in October 2015, news emerged that the company was being fined $5.2 billion for a delay in disconnecting subscribers who were improperly registered on MTN's Nigerian network.

The magnitude of the fine was extraordinary by global standards, for any industry. Previously, the largest telecommunications fine was $1.3 billion, levied on Djezzy Telecom for breaching foreign exchange regulations in Algeria in 2012. In other industries, the largest fine given by the US Justice Department to an automotive manufacturer was $1.2 billion in 2014 to Toyota after a faulty accelerator mechanism led to 37 deaths. General Motors was fined $900 million for an ignition switch defect that caused 174 deaths. Earlier this year, a BHP Billiton and Vale joint venture negotiated a settlement of $1.1 billion over 15 years for compensation and repair costs following a dam disaster in Brazil that caused 17 fatalities.

Subscriber registration has been an ongoing process in Nigeria. The requirements are onerous (akin to the biometric capturing of individual details) and obtaining complete subscriber information in the absence of a national identity database is difficult. A new, more security-conscious political regime felt it was imperative to have a quick cleanout of unregistered subscribers in an effort to tackle terrorism. Mobile operators were given seven days to comply. According to the Nigerian regulator only MTN did not meet this deadline.

This assertion was not easy to confirm or dispute at the time. However, our channel checks with competitors and ex-employees, as well as analysis of the quarterly reported subscriber numbers published by the Nigerian regulators, seemed to suggest that MTN had been singled out. The official data (shown in the bar graph below) show that, in the third quarter of 2015, only MTN showed net subscriber disconnections. Every other operator (Globacom, Airtel and Etisalat) showed net additions – despite the regulatory requirement to disconnect unregistered users.

MOBILE SUBSCRIBER CONNECTIONS AND DISCONNECTIONS IN NIGERIA



Sources: Nigerian Communications Commission (NCC) and Citi Research

In addition to the fine, the Nigerian regulator also proceeded to suspend regulatory services to MTN. The suspension of these services effectively hamstrung MTN's competitive position as it was not allowed to implement any promotions or new tariffs. This led to a direct loss of market share to competitors. The quantum of the fine and the suspension of services highlighted the extent to which the relationship between MTN and the Nigerian regulator had broken down.

The share price reaction to these events was swift and brutal. In the space of three months, the market wiped $10 billion off the market capitalisation of the company, almost twice the initial fine amount. News headlines from the Nigerian press were extremely negative, unofficial comments from the regulator were not encouraging and there was no consistency in the official communications on the fine. In December 2015, MTN was notified that the fine was reduced by 35%. Then, a day later, this was changed to 25%! Compounding the relentless newsflow was further macro pressure with poor Nigerian GDP growth and investors questioning the sustainability of a pegged exchange rate.

Although we held MTN in our portfolios when the fine was announced, it was an underweight position across most of our funds. While there was a lot of conflicting newsflow and confusion following the fine announcement, we thought that the share price presented an interesting investment opportunity. The market's attention was focused only on Nigeria: the negative issues around the fine, the economy and the exchange rate. While it is a big market for MTN, its other key operations in Iran and Ghana were performing well and SA was staging a recovery after years of underperformance. All operations were generating good cash flow.

Also, the company was using the tough economic environment in Nigeria to deepen the moat around its business. Despite the tense regulatory relationship, MTN still managed to renew its mobile licence for a reasonable payment and received approvals to make spectrum acquisitions. With the growing demand for data services in Nigeria, this would expand MTN's network capability and entrench its market leadership.

By March 2016, regulatory services were restored, allowing MTN to once again be competitive in the market from a pricing perspective.

MTN's share price also posed very little downside from a valuation perspective. It had already more than discounted the full initial fine amount of $5.2 billion. The company had a fortress balance sheet with no net debt and was in a position to pay the full fine amount without the need to raise equity capital. Even after adjusting for the fine, the market's rating of the business looked very cheap compared to a basket of emerging market telecommunication peers.

The shock of the fine had also prompted a deep introspection within MTN and a recognition by the board that some fundamental changes to the company's culture and strategy were required. Chairman Phuthuma Nhleko stepped into the CEO role on an interim basis to implement some of these changes. The company made the decision to increase its capital expenditure programme in key markets. Fresh management and board skills were brought in to enhance governance, improve the culture and unlock efficiencies. Our previous experience has taught us that it is dangerous to underestimate the long-term benefits of a high-level change in direction, especially in a business that was not achieving its full potential.

With this long-term perspective in mind, we took the decision to increase our MTN position and moved to an overweight position in our funds. Our discussions with competitors and regulators, as well as with board and management members, solidified our view that regardless of the final amount to be paid to resolve the fine, the company was on the path to making fundamental business changes. None of this was reflected in the market price.

Towards the end of June 2016, the fine was settled at $1.7 billion, payable in instalments over three years. The present value of this fine is much lower at around $1 billion. Subsequent to that, the Central Bank of Nigeria announced a move away from the pegged currency towards a more flexible exchange rate regime. With this implemented, dollar availability has improved in the country and businesses should be able to extract cash from Nigeria. Finally, we saw the announcement of Rob Shuter as the new MTN group CEO. Shuter will be a positive appointment for MTN as he has financial experience from his time with Vodacom as financial director, as well as operational experience as CEO of Vodafone's European cluster. We think he will bring good capital allocation skills and improved operational discipline to MTN. He is further supported by a strengthened board, which now also includes Paul Hanratty (formerly with the Old Mutual Group) and Stan Miller (from the US investment company Capital Group and executive chairman of MTS, a Russian mobile operator) among others.

It was not an easy or a comfortable decision to increase our position size in MTN. But the fear in the market granted us an opportunity to make an investment which would be to the long-term benefit of our clients. The resolution of these issues will bring about some short-term pain for the group, but the overall business fundamentals still look attractive. MTN has a market-leading footprint in key countries that is very difficult to replicate. While not immune to macro pressures, it has a relatively defensive business model. Data penetration across key markets is still at very low levels and growth will be supported by the increased availability and affordability of smartphones. Its balance sheet strength is not to be underestimated. In most markets, competitors are unable to match MTN's level of capital spend on its network. The business is able to fund elevated capital expenditure, while still supporting a decent dividend yield.

All of these factors, along with improved management and board skills, will be a powerful combination that can deliver good long-term returns to the patient long-term investor.

The importance of institutions

SA will not grow without a strong support structure.

by **MARIE ANTELME**

***MARIE ANTELME** is an economist in the fixed interest team. Marie joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.*

It is hard to deliberate on the key constituents of a functioning society and economy when you are hungry. And it is even harder to believe in the importance of these institutions when the same society or economy has failed to provide you with an education, or a job, or the means with which to feed your family.

There is a wide range of institutions that support societies, incorporating structures that defend property rights and the legal framework, including the court system; the political system and the framework within which government operates; institutions which regulate economic and financial stability; and those that provide social insurance and safeguard security (including the police and military). As such, these institutions make up the fabric within which citizens, businesses, political parties and the economy operate, and provide a framework of rules, social norms and understood processes that are both explicit and implicit.

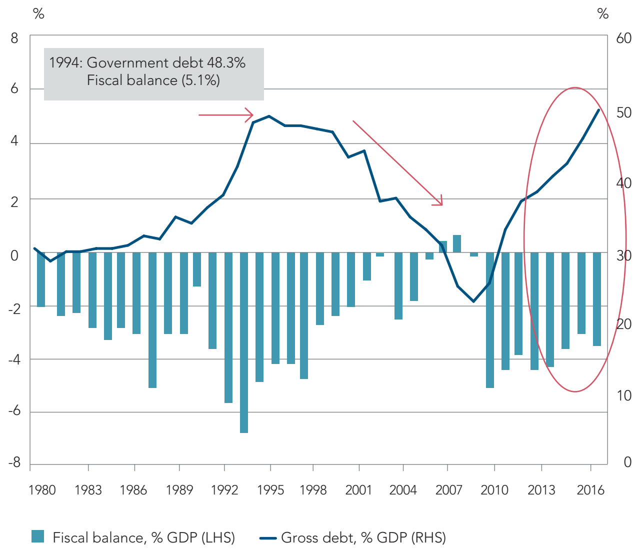
State institutions are an economy's primary facilitator of social and economic development. Research shows that these institutions can be a major source of growth; effective institutions aid investment in physical and human capital, in research and development, and in technology. Institutions also have an important redistributive role to play in the economy – they make sure that resources are properly allocated, and ensure that the poor or those with fewer economic resources are protected. They also encourage trust by providing policing and justice systems which adhere to a common set of laws. Properly functioning institutions are a signal of a well-managed economy, enabling governments – and businesses – to borrow money more cheaply. In turn, higher growth and lower borrowing costs give governments the resources to spend on social needs as well as on investment into infrastructure, health and education.

The reverse is also true. Failed or ineffective institutions undermine trust, raise the cost of doing business and increase the cost of government borrowing, limiting the ability of government to spend. If a government does not carefully manage its expenditure, rising borrowing costs can quickly lead to a debt spiral from which recovery is difficult, and where everyone suffers, but the poor the most.

One of the biggest challenges for the first democratic government in SA was stabilising and reinforcing a very weak economy. The government inherited an enormous stock of debt and a budget framework with persistently large deficits. Ongoing massive government spending fuelled a large external deficit too, and the currency was vulnerable and prone to weakness. Inflation was rampant and interest rates volatile. Wealth and economic resources were highly concentrated along racial lines, and for the majority of the country, basic needs were not met. All of these issues reflected a failure of state and economic institutions under the apartheid government.

At the time, the ruling ANC government took the tough decision to rein in spending, to recapitalise the state pension fund (which had been plundered), and to create a transparent long-term budgeting process which anchored fiscal policy to a sustainable path.

SA GOVERNMENT DEBT AND FISCAL BALANCE



Sources: Coronation, Oxford Economics

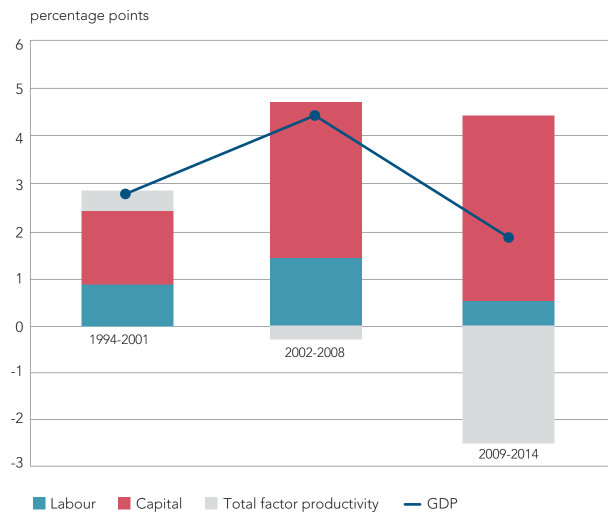
A new constitution helped provide the framework for other institutions, and a commitment to growing, entrenching and protecting these institutions helped restore confidence and steered the economy onto a better growth path and a fiscally strong position. Over time, this commitment helped lower funding costs. Ratings agencies acknowledged the progress and upgraded their sovereign ratings for SA well into investment grade. The state was now able to spend on social grants, to provide basic services to the poor, to reduce its debt and fund its spending at more reasonable levels.

There has been considerable slippage in some economic institutions since the global financial crisis. Fiscal policy has much less flexibility because after government increased spending to alleviate the impact of the recession, it never really reduced it again, borrowing in order to finance the spending and adding steadily to the country's debt stock. Consolidation of the deficit has been very slow because expenditure – mostly on wages – has grown so fast.

Policy uncertainty has also played an important role in undermining the effective functioning of domestic institutions; ranging from delays in the Mineral and Petroleum Resources Act, uncertainty about a possible (though likely) national minimum wage, conflicting information about the status of the nuclear programme and state policy on electricity provision, as well as the effectiveness of state-owned enterprises. This can be seen in very weak employment growth (outside of the state), and the slow recovery of private sector investment.

A range of challenges – from unemployment, poverty, inequality, Eskom's capacity constraints, the ability of the state to provide adequately for the ravages of the drought, to disastrous decisions around tourism policy, immigration and emigration – have fuelled social unrest and service delivery protests, which have intensified as the economy struggled to grow. These are all reflective of institutions which are not functioning effectively.

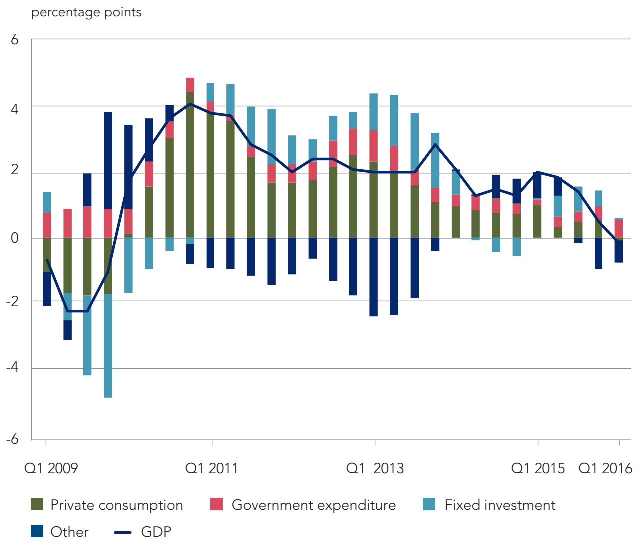
SA CONTRIBUTIONS TO GDP GROWTH



Sources: Coronation, Conference Board, UBS

Against this backdrop, it is unsurprising that SA's economic growth has slowed so much, even without the devastating drought and the negative impact of falling commodity prices on the mining sector. The long-term drivers of growth – capital expenditure, employment and gains in productivity – have all weakened and remain markedly below the precrisis levels. Ratings agencies responded to an increase in sovereign risk with downgrades to SA's outlook at the end of last year.

CONTRIBUTION TO REAL GDP GROWTH RATE BY EXPENDITURE COMPONENT



Sources: Coronation, SA Reserve Bank, Datastream

There is a glimmer of light. National Treasury has managed to consolidate its fiscal deficit, beating its 2015/2016 fiscal target of -3.9%, and delivering a deficit of -3.3% despite the weakness in economic growth. A hard line on expenditure helped. National Treasury is also overseeing a number of programmes to remove the constraints on doing business, including a review of port tariffs, concessions on the new visa requirements, tender and procurement reviews. All of this should help. Elsewhere, Eskom has managed to increase both maintenance and capacity, eliminating blackouts and the associated disruption on economic output. A review of labour market constraints – notably introducing ongoing negotiations to agree on a strike ballot – is underway. These efforts have been enough to stave off ratings action from all three agencies, and kept the country's sovereign ratings just inside the limits of investment grade.

It is clear that the effective functioning of SA's institutions is a crucial precondition for economic growth. The vagaries of factors such as weather, global shocks and commodity prices cannot be avoided, but institutional strength is the responsibility of all people in a democratic system. The path to sustainably raising economic growth is littered with tough choices, and the process is not easy. But history shows us that there is no more effective way of helping societies improve the lives of their members, especially those most vulnerable, than through economic growth.

Many happy returns

The Coronation Balanced Plus and Equity funds celebrate two decades of strong investment growth.

by **PIETER KOEKEMOER**

***PIETER KOEKEMOER** 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.*

In April 1996, Coronation, then a fledgling investment firm, launched two new funds from its small office in Cape Town.

The Coronation Equity Fund aimed to give investors the best possible returns over the long run by investing in a wide range of equities. The fund is fully invested in shares, which offer the highest expected growth over the long run. Its investments are predominantly in SA, with an allocation of up to 25% in international equities, plus a further 5% in Africa (outside of SA).

The Coronation Balanced Plus Fund was a pioneering investment product, one of the first to invest in a wide variety of assets, such as shares, bonds, listed property and cash (both in SA and abroad) to achieve investment growth for retirement savers. The fund complies with Regulation 28 and has a strong bias towards shares. This investment is carefully balanced with other less volatile assets (including cash and bonds) to manage risk and provide a smoother return path.

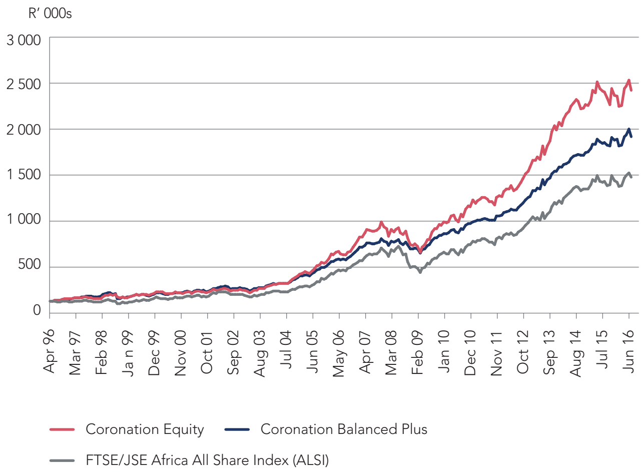
Both funds remain the top-performing funds in their respective categories since launch. Over the years, the funds have delivered market-beating investment returns for our clients who chose to remain invested during the various market ups and downs.

One investor, a 60-year old woman, invested R20 000 in the Balanced Plus Fund and R30 000 in the Equity Fund on 12 June 1996. Twenty years later, her initial combined investment of R50 000 is now worth more than R1 million. She did not invest another cent and never withdrew money; she simply stayed the course and reinvested her distributions every six months.

A family with two small boys invested R16 666 for each of them in the Equity Fund on 16 April 1996. They contributed a R500 debit order for each of them for another 17 months. Tim and Steve are now 23 and 25 years old, and that initial investment has grown to just shy of R568 000 for each.

Many of our other long-term clients have seen similar investment growth. They are living proof that if you remain invested in the equity markets for extended periods, and stick with a judicious fund manager for the long haul, the power of compounding will do extraordinary things for you. Money invested generates returns that can be reinvested to achieve further returns. Over time, this can create enormous wealth.

R100 000 INVESTED SINCE INCEPTION



Source: Coronation

Unfortunately, most investors capture only a fraction of this combination of market and active return over time. They move in and out of funds in reaction to news events and talk around the braai. We believe that jumping from fund to fund to chase the best return will erode wealth over time.

The fact is, the short-term focus of markets means that the long-term prospects of financial assets often diverge from current prices. Overreactions to short-term 'noise' will push prices to unjustified levels. This is where we believe we can add value: through exhaustive research we actively seek out undervalued shares that could achieve strong investment growth over the long run.

For example, both funds have pursued select opportunities created by the brutal sell-off following the Brexit referendum. The funds have increased their exposure to a number of shares that have been sold down to compelling levels. More market volatility is expected and it may take some time for these investments to unlock value. However, patient investors in our funds are comfortable with periods of short-term underperformance in the service of substantial results over the long term.

We are in the business of creating wealth over many years, and we encourage our investors to only make changes in their portfolios when their needs have changed, and not in response to recent market movements or short-term performance experience.

Bond outlook

'If you want the rainbow, you gotta put up with the rain.' – Dolly Parton

by **MARK LE ROUX**

__MARK LE ROUX__ is head of Coronation's fixed interest unit. He joined Coronation in 2005, after holding portfolio management positions at Old Mutual, African Harvest and Decillion.

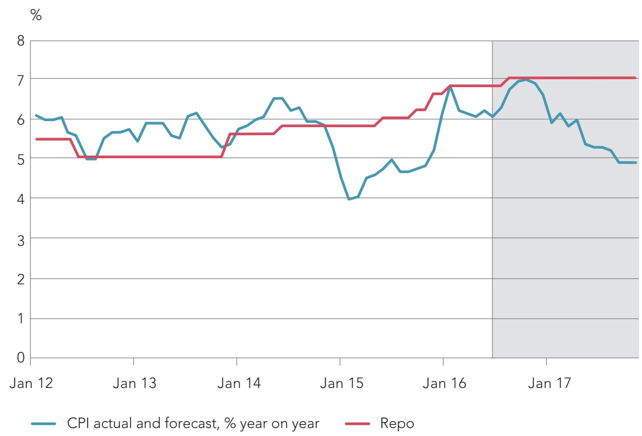
The SA bond and currency markets have had their fair share of bad weather in the past few years. The bond market has seen yields (as referenced by the 2026-maturing government bond) bottom out at 6.9% in May 2013 and sell off to a peak of 10.5% in December 2015 after the replacement of then finance minister Nhlanhla Nene. Benchmark yields have settled at around 9% for now. The downpour in the currency market has been worse, more a torrent or a flood than a shower. The rand bottomed at R6.50 to the dollar in May 2011, before depreciating sharply following the Marikana tragedy in mid-2012 to spike at R17.91 in January 2016. It was trading at R14.30 to the dollar at the time of writing.

The most important question for the fixed income market now is whether the worst of the storm is behind us. Was December 2015 the eye of the storm, and will the shock to inflation that followed start to recede? Or is there more to come? Importantly, is the first glimmer of a rainbow about to emerge as drought-related food inflation hits a peak in the next few months before possibly receding?

In response to the upside risk to inflation posed by the drought and the weaker currency, the Monetary Policy Committee (MPC) continued to raise the repo rate this year, with 75 basis points (bps) of rate increases up to May 2016. Since the start of the rate normalisation cycle in January 2014, the MPC has raised the repo rate by a cumulative 200 bps to its current level of 7%. Meanwhile, the economy has weakened significantly, with growth first slowing and then contracting by 0.6% year-on-year in the first quarter of 2016. Inflation is expected to peak in the fourth quarter of 2016, and already actual data have started to surprise to the downside. Could this imply that the SA Reserve Bank (SARB) has done enough? The answer has to be in a combination of the outlook for inflation, and then growth.

We think inflation is close to peaking. The most important driver of the recent rise in inflation is food prices. It is very unusual to have two consecutive years of high food prices – especially driven by high maize prices. Conditions invariably normalise as farmers overplant to take advantage of high prevailing prices; a year of high prices is usually followed by a bumper crop and high food stocks which spill over to the following years. However, given the reported severity of the drought and concerns that some farms may no longer be able to produce (due also to fire sales and long-term damage), there was a considerable risk to this view. Subsequently rain has been reported in key areas in May, and there is some solace that a 'normal' rainfall in August to September this year would be enough to generate a 'normal' yielding maize crop, and also that peripheral farms will be bought or rented and planted. This gives us comfort that a more traditional moderation in food prices may be expected next year.

INFLATION VS REPO RATE



Sources: Coronation, Statistics SA and SA Reserve Bank

There is also a growing concern that SA consumers are now really coming under pressure. There was an outright contraction in household consumption expenditure in the first quarter of 2016, which coincided with a drop in (albeit volatile) personal tax revenue in March and very weak underlying credit and vehicle sales data. A combination of high inflation in food staples (c. 29% year-on-year in the first quarter of 2016), very limited tax relief in February, job losses in the first quarter of 2016, slowing real income growth (especially in the public sector) and a broad unwillingness to spend among wealthier consumers, are all increasingly in play. This will challenge both growth and the ability of companies to hike prices.

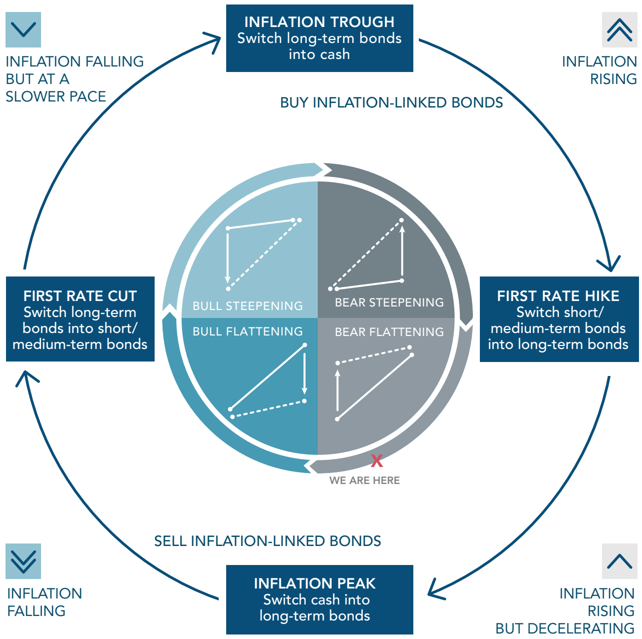
Household spending is a key determinant of GDP growth. GDP contracted by 0.6% year-on-year in the first quarter of 2016, with household spending and fixed investment remaining weak and net exports a neutral contributor to growth. Government spending picked up a little, offsetting some of the weakness, but this is insufficient to boost overall activity this year.

Early indications for the second quarter are weak too. Corporate profitability is under significant pressure, employment contracted during the first quarter, and the only growth support may come from trade – although the recent Brexit vote could compromise UK demand for domestic exports. Certainly, the last SARB MPC statement highlighted greater concern for the growth outlook than at previous meetings. Structural impediments to growth persist. The labour market is inflexible and productivity is low, and investment in capacity has been hampered not only by poor global growth conditions, but also by unhelpful policy uncertainty. Domestic GDP is unlikely to grow by more than 0.5% this year, and perhaps by 1 % in 2017.

Taken together, this implies inflation is likely to be much lower in 12 to 18 months than it is now. What does that mean for the fixed interest investment cycle and the valuation of our long bonds?

The following flowchart clearly indicates that as one moves towards the inflation peak, and in the process begin to discount the top of the rate cycle, that is the right time to begin accumulating long bonds and lengthening the duration in fixed interest portfolios. However, it is crucial to ensure that the fixed interest investment cycle argument is also supported by the underlying valuation of local bonds.

BOND INVESTMENT CYCLE



Source: Coronation

One of the methods we use to calculate a fair valuation for SA long bonds is to use the three fundamental components that determine the yield:

- A global long bond rate (we use the ten-year US treasury);
- We then add an expected inflation differential between the SA and US markets (basically, SA expected inflation minus US expected inflation); and
- Finally, the SA sovereign spread, which aims to capture the SA risk premium in the yield.

Our calculations point towards a fair value of 8.5% for the ten-year SA government bond, as detailed in the following table.

FAIR VALUE CALCULATION OF 10-YEAR SA GOVERNMENT BOND

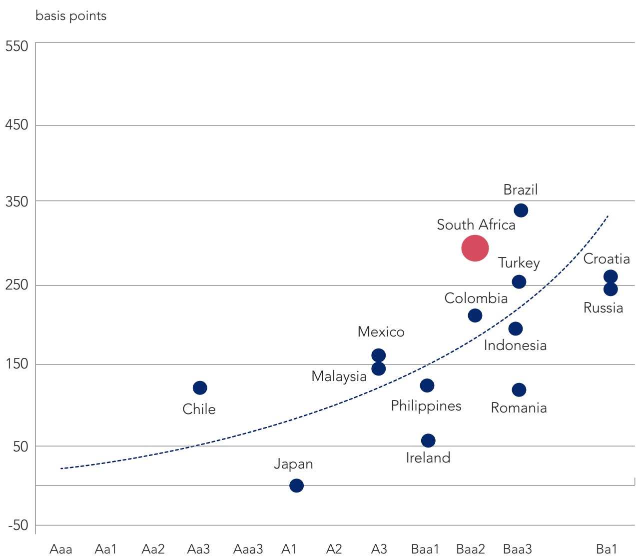
US 10-year Treasury	1.7%
SA expected inflation	5.5%
US expected inflation	(1.5%)
SA sovereign spread	2.8%
Fair value	8.5%

Source: Coronation

Currently, the SA ten-year government bond trades around 9%. Should yields start falling and the bond trades closer to the calculated fair value, it would offer a total return over a 12-month period of approximately 12%.

Another potential positive underpin of this valuation could come from the SA sovereign spread. The chart below shows that current valuations are discounting a ratings downgrade to junk status. Should SA manage to get another stay of execution from junk status in December, then there could be scope for that spread to tighten to be in line with the trading levels of an investment grade country.

THE RATINGS GAP: CREDIT DEFAULT SWAP RATES VS MOODY'S RATINGS



Source: Bloomberg

In our valuation metrics, a significant risk is the possibility of a derating in US bond yields. The US ten-year bonds are currently trading at historically low levels, which may move back to more normal levels should the Federal Reserve increase the pace of the hiking cycle in the US.

In conclusion

Growth in SA has been generally disappointing following the global financial crisis, but despite this, inflation has remained relatively high, rising through 2015 and into this year. There is considerable uncertainty about how high headline inflation can climb. These stagflationary conditions have made policy setting very hard, and domestic political flux has not helped either.

The recent sharp deterioration in growth suggests that the economy may now simply be too weak to absorb much price pressure. Also, better conditions for grain planting may alleviate some of the stress from rising food inflation in the months ahead. Bar any unexpected political risk event, these circumstances should support a near-term peak in inflation and much better prospects for bond yields over the next 12 to 18 months.

Market review

The global outlook has deteriorated in the aftermath of Brexit.

by **DUANE CABLE**

***DUANE CABLE** joined Coronation in 2006 as an investment analyst and was appointed Head of SA Equity in 2013. He co-manages all portfolios within the Absolute Return offering.*

In US dollars, the MSCI All Country World Index returned 0.99% for the quarter and -3.7% for the 12 months to end-June, while the MSCI Emerging Markets Index returned 0.7% for the quarter and -12.1% for the 12-month period. Locally, the JSE All Share returned 0.1% for the quarter and -14% for the 12 months to end-June in US dollars.

The recovery in commodity prices continued into the second quarter with some of the notable moves (in US dollars) being a 25.4% increase in the price of oil, 7.2% in gold and 5.0% in platinum. The recovery in commodity prices provided a tailwind for resource shares, with the local resources index increasing 6.4% over the quarter, outperforming industrials (0.5%) and financials (-4.3%). However, the longer-term underperformance of resources relative to industrials and financials remains stark.

MARKET REVIEW

Index	2nd quarter 2016	1 year	3 years	5 years	10 years
All Share	0.4%	4.1%	13.2%	14.0%	12.8%
Resources	6.4%	(1.5%)	2.3%	(3.1%)	2.1%
Financials	(4.3%)	(2.7%)	15.4%	18.5%	13.1%
Industrials	0.5%	7.8%	17.1%	22.1%	20.0%
SA Property	(0.4%)	11.1%	14.2%	18.4%	18.6%
All Bond	4.4%	5.2%	6.3%	7.9%	8.4%
Cash	1.8%	6.9%	6.2%	5.9%	7.3%

Source: Deutsche Bank

The UK referendum on membership of the EU certainly dominated the headlines during the second quarter of 2016. As the surprise result of the referendum (52% of voters supported leaving the EU) flashed across news screens on 24 June, we saw a significant sell-off in risk assets around the globe. The pound also significantly weakened against the US dollar, to levels last seen in the mid-1980s. Increased levels of uncertainty pose the biggest risk in the wake of the Brexit vote. Already, the global economic outlook in the aftermath of Brexit has deteriorated as investors and consumers delay spending decisions amid the uncertainty.

It is hard to believe that nearly eight years after the global financial crisis, markets remain dependent on unprecedented monetary stimulus. Our base case remains that the pace of interest rate normalisation will be gradual and that interest rates will remain at historically low levels for even longer. The large-scale monetary stimulus and record-low (in some cases even negative) interest rates are continuing to inflate financial assets around the globe as investors search for yield on their investments. Although we must be close to reaching the limits of further monetary stimulus, most governments are still able to deploy fiscal stimulus (i.e. an increase in public spending or reducing tax to encourage economic growth). The increased levels of frustration among the working class around the globe about the lack of economic growth and rising unemployment levels will continue to add pressure on politicians to use whatever tools they have at their disposal to improve the growth outlook and avoid being voted out of power. The prospects of continuing monetary stimulus and the potential for fiscal stimulus will provide some tailwind for risk assets in this increasingly uncertain and volatile environment.

The SA economic growth outlook remains anaemic and risks are certainly to the downside against the backdrop of a weaker global economy. The rating agencies have granted the country a reprieve from being downgraded to junk status, but this is likely to be temporary, unless we see real action to address financial conditions at state-owned enterprises before December.

Increased political uncertainty, low growth and high inflation will plague the local economy in the short term. In the context of weak local and global economic growth, our base case is that domestic interest rates are at, or very close to, a peak.

We have used the recent market correction to add to our local equity holdings, on the basis of their compelling longer-term valuations. We continue to favour the quality global businesses that happen to be domiciled here, such as Naspers, British American Tobacco, Steinhoff and Anheuser-Busch InBev. These companies have robust business models, are diversified across numerous geographies and currencies, and remain attractive based on our assessment of their intrinsic value.

Based on our assessment of fair value, resources are attractive enough to warrant a reasonable weighting in our equity and balanced portfolios. However, given that China remains an imponderable, this is not a portfolio-defining position. Our preferred holdings remain Anglo American, Mondi, Exxaro and the platinum producers. We continue to favour platinum over gold producers and our preference remains the low-cost platinum producers Impala Platinum and Northam.

We continue to hold reasonable positions in the food retailers and producers as well as selected consumer-facing businesses (chiefly Woolworths and Foschini). These businesses are exceptionally well managed and trade below our assessment of their fair value.

Banks returned -3.1% for the quarter, outperforming the broader financial index. Valuations are attractive on both a price-to-earnings and price-to-book basis. Our preferred holdings are Nedbank, Standard Bank and FirstRand. Life insurers returned -6.6% for the quarter. We prefer Old Mutual and MMI Holdings, both of which trade on attractive dividend yields and below our assessment of their intrinsic value.

In terms of asset allocation, equities remain our preferred asset class for producing inflation-beating returns. We prefer global to domestic equities on the basis of valuation and remain at the maximum 25% offshore limit in our global balanced funds.

Listed property returned -0.4% for the quarter. We expect domestic property holdings to deliver reasonable distribution growth over the medium term, which, combined with a fair initial yield, offers an attractive holding period return. We continue to hold the higher-quality property names which we believe will produce better returns than bonds and cash over the long term. Although the news of Brexit is clearly negative for our UK-based holdings in Intu and Capco in the short term, we believe the sell-off has more than priced in these risks, and both stocks now trade at large discounts to our assessment of their intrinsic value.

The bond market returned 4.4% for the quarter, outperforming cash, which yielded 1.8%. We believe yields on global bonds are too low and do not offer value. The outlook for local bonds is relatively well balanced and the asset class offers reasonable value relative to cash over the long term.

In an incredibly uncertain world, we continue to strive to build diversified portfolios that could absorb a dramatic change in the strong momentum seen in markets over the last few years. We will remain focused on long-term valuations and will seek to take advantage of whatever attractive opportunities the market presents us to generate long-term returns for our investors.

MARKET MOVEMENTS

	2nd quarter 2016 %	Year to date 2016 %
All Share Index R	0.4	4.3
All Share Index $	0.1	9.7
All Bond R	4.4	11.2
All Bond $	4.1	17.0
Cash R	1.8	3.6
Resources Index R	6.4	25.7
Financial Index R	(4.3)	1.6
Industrial Index R	0.5	0.1
MSCI World $	1.2	1.0
MSCI ACWI $	1.0	1.2
MSCI EM $	0.7	6.4
S&P 500 $	2.5	3.8
Nasdaq $	(1.1)	(3.2)
MSCI Pacific $	0.9	(2.8)
Dow Jones EURO Stoxx 50 $	(5.1)	(8.2)

International outlook

Globalisation under the spotlight.

by **TONY GIBSON**

***TONY GIBSON** is a founder member of Coronation and a former CIO. He was responsible for establishing Coronation's international business in the mid-1990s, and has managed the global equity fund of funds product since inception.*

In recent months global investment markets have had much to fret about – whether it be Brexit, worries over the post-Obama leadership in the US, the migration crisis, wavering confidence in the strength of the US economy or deflationary fears in Europe. In our opinion, the clear growth of populism (best exemplified by the utterances of Donald Trump) has unsettled investors the most. Markets are no doubt alarmed that 'even' the US economy is falling prey to protectionist and populist statements. Additionally, investors are concerned that globalisation is seen to be failing in advanced Western countries. Once hailed for delivering universal benefit, it is now facing a political backlash. The reason for this, it seems, is the delayed (but inevitable) effects of financial repression.

This is the phenomenon whereby central banks aggressively intervene to lower interest rates to effectively zero, in the hope that it will stave off deflation. The consequence of this strategy has been that, while staving off deflation, savers are penalised. Additionally, while the financial position of the median worker in the US has deteriorated in real terms since 2006, a small but very visible component of the business community has made extraordinary amounts of money. This is an environment in which antimigration sentiment flourishes as it is seen to be the reason for the lack of economic progress suffered by the working class. Similar sentiments are being expressed in Europe – exacerbated by the migrant crisis.

Accordingly, critics of globalisation contend that Western countries are failing to cope with the economic shocks that inevitably result from closer integration, particularly the stagnation of real average incomes for two decades. Another shock was the global financial crisis itself, seen as a consequence of globalisation, with its permanent impact on long-term economic growth.

A stark example of antiglobalisation sentiment is the dramatic reversal of public opinion in Germany about the benefits of free global trade in general. In 2014 almost 90% of Germans were in favour of free trade, according to a poll. That has now fallen to 56%. The number of people who outright reject the Transatlantic Trade and Investment Partnership (a proposed trade agreement between the EU and the US) has risen from 25% to 33% over the same period of time. Although these numbers do not suggest that the EU will become protectionist, the fast shift in those figures is a worrying trend. In many European countries, globalisation and technical innovation have together destroyed the jobs of the working classes. Now these factors are threatening the livelihoods of the lower middle class. Accordingly, a revolt among voters is unsurprising

While workers in the West remain wealthy compared with most others around the world, their incomes and benefits have stopped improving and, more ominously, are increasingly deemed unaffordable. This has fuelled social uncertainty and the rise of anti-establishment politicians through Europe and now the US. Essentially, electorates believe there is insufficient factual evidence that countries that have reformed are performing better. The US and the UK have more liberal market structures than most of continental Europe. Yet the UK is exiting the EU and in the US the Republicans may be about to nominate an extreme populist as their presidential candidate. Politicians who advocate global market liberalisation are being forced to face up to the notion that both globalisation and European integration are increasingly seen as failures. Both were supposed to produce a situation where nobody should be worse off, while some might be better off. The key point is that if the politicians do not take action, the voters surely will.

Meanwhile, the influence of the global economy on the decisions of the US Federal Reserve (Fed) has become a topic of frontline importance in recent months. Since the start of 2016, events in foreign economies have conspired to delay the Federal Open Market Committee's intended 'normalisation' of domestic interest rates, which had apparently been set on a firmly determined path last December. But the key question now is whether weak foreign activity will continue to trump (no pun intended) domestic strength in the US. The US central bank certainly has no responsibility to take direct account of the welfare of foreigners. That said, the impact of events overseas on the dollar and the domestic US economy are too important to be entirely ignored.

Remarkably, the ten-year German Bund yield reached a record low of -0.17% in the wake of the Brexit vote. The ten-year US Treasury note is around 1.45%. These bonds are now trading below the yields during the depressionary period of the 1930s and 1940s. This does suggest a serious bubble, representing a bigger problem in government bonds around the globe than what we saw following the technology bubble during the late 1990s. As has been well signalled, the Fed seems intent on normalising rates, albeit at a slower pace than in the past. While this may be undesirable, what the Fed does (or does not do) is critically important for the market. It seems the bond market is currently expecting two to three rate increases, followed most likely by a recession.

We disagree with that. While secular headwinds will pose a formidable barrier to global growth over the medium to longer term, a cyclical rebalancing should buoy growth over the next two to three years. As mentioned, fears of an impending recession in the US have been on the rise – both because the current expansion is growing tired and because declining profits are seen as a signal for firms to cut capital spending and hiring. We believe these fears are exaggerated, for several reasons. First, economic expansions do not necessarily simply end due to the flux of time. Rather, they die of natural causes, including overinvestment imbalances, policy tightening, and other exogenous or external shocks. Secondly, although profit growth rates have declined significantly over the past year and a half, this has been from extremely high levels. Profit margins are still quite high by historical standards – well above levels normally seen as the economy nears a recession. Margins normally peak at mid-cycle, not at the end of a cycle, and they decline for a number of years as the expansion matures.

We do not currently detect any of the various potential natural causes of recessions in the US. Frequently, it is aggressive Fed tightening in response to rising inflation pressures that induces downturns, but that prospect still seems a couple of years away. Overinvestment in housing and/or business capital has also been a traditional culprit, but underinvestment has been the mode so far in this expansion. Looking at other conventional causes of a recession in the US, oil shocks have often been major contributing factors. However, the shale industry has become a buffer to potential price spikes going forward, thereby arguing against this as a cause. China may offer a new potential shock, but Chinese officials seem to have both a desire to avoid and the resources to deal with any disruptions that do arise.

The more bearish commentators will point to recession probability models that suggest that the likelihood of a downturn has increased in recent quarters. These models, and indeed the economic profession, do not have an especially good record in predicting recessions a year or two out. In our opinion, a recession is not the most likely outcome over the next two years, with current conditions certainly not favouring a severe recession any time soon. This is validated by the fact that the median US worker enjoyed a pay increase of 3.5% year-on-year in May, according to the Federal Reserve Bank of Atlanta's wage growth tracker. Wage growth has been accelerating since October, quickening to a pace not seen since January 2009. This measure of wage growth is far from the only metric suggesting that the US labour market might be close to full employment. The National Federation of Independent Business (NFIB) Small Business Optimism report for May indicated that finding quality labour remains one of employers' biggest problems. Citing anecdotal evidence, the NFIB reported that the 'failure rate' rose over the course of the month, as the share of owners who could not fill a job opening lingered at historically high levels.

What will, ultimately, cause the US economy to move into a recession will be the slow but inevitable climb back to positive real interest rates, which will also increase the cost of debt service for many countries and corporations. While companies may have locked in longer-duration debt, most countries had been short-sighted and face a surge in net interest costs. While the timing of the climb will have a significant impact on near-term capital flows and asset allocation by country and industry, the end destination is still likely to be a rise of

200 basis points to 250 basis points in the Fed funds rate (and much of the US yield curve) over the next 24 to 36 months.

The primary reason for our view is the expected ripple effect of the year-on-year rise in energy prices over the next 18 months, which may prove to be a major catalyst of rate hikes. This will increase consumer prices and therefore boost (already rising) cost-of-living wage hikes. While the media and many investors focus on tepid year-on-year inflation in the US (up only 1.1% in the year to April), less attention is paid to the measure of consumer price index (CPI) less food and energy – which has been at or more than 2% year-on-year since November 2015, despite the ripple effect of sharply lower energy prices. With year-on-year energy prices poised to rise sharply during the remainder of 2016 and into 2017, top-line CPI is likely to rise above 2%. As a result, a normalised Fed funds rate would be 2.5% or higher by 2018.

That said, while the Fed will lead the climb towards positive real interest rates, it will be followed only after a considerable lag by the Bank of Japan and the European Central Bank. As a result, money is likely to rotate towards the dollar and US financial assets again. Despite popular belief, such a modest real rate of return may actually stimulate rather than dampen economic activity.

Looking at equity markets, some perspective is called for. Seven years of the Fed's zero-interest rate policy have resulted in an increasingly over-extended search for yield. This has inflated valuations of many financial assets to historically high levels. Additionally, US equity markets have also experienced an extreme divergence since mid-2014 as the collapse in commodity prices and exceptional US dollar strength stoked fears of an industrial recession, which depressed the share prices of many value stocks and drove investors into perceived safe-haven assets, such as passive large-cap exchange traded funds (ETFs), mega-cap consumer staples and growth stocks. This equity market dynamic caused many investors to crowd into momentum stocks, inflating their valuation premiums over value stocks to levels not seen in the past 35 years, other than during the tech bubble period of 1998 to 2000.

As context, in 1998, the Asian financial crisis and collapse of Long-Term Capital Management created major macroeconomic disruptions and raised fears of systemic risk that caused equity markets to experience a sharp bifurcation. At that time, fear caused capital to leave the equity markets, while the remaining investments tended to gravitate towards large-cap stocks. The rise of passive investing (via ETFs and index funds) during the mid-1990s had already channelled large amounts of capital into large-cap and growth companies, particularly those focused on the internet, resulting in significant share price appreciation. As investors grew concerned about the macro environment, they crowded into these 'safe' investments. Value stocks, particularly small and mid-caps, became a source of cash and underperformed in late 1998.

By the end of 1998, the ten largest technology stocks, including Microsoft, Intel, Cisco, AOL and Yahoo, had gained an average of over 140%, driving the Nasdaq Index up 40% and the S&P 500 Index up 29% for the year. The S&P 500 Equal-weight Index gained only 10% in 1998, while most value managers performed well below that level. This extreme divergence reinforced itself over the next 18 months, as investors ignored fundamental analysis and rotated further from value into growth and momentum names. While the AOL-Time Warner merger in January 2000 should have rung a 'bell at the top', as it revealed the enormous gap between the prices and fundamentals of many growth companies, the actual inflection point for US equity markets came in March 2000. The ensuing collapse of the tech bubble triggered a long-overdue rotation back to value and initiated a seven-year cycle, from 2000 to 2006, during which value outperformed growth. Despite global economic growth that fell well below trend from 2000 to 2003, active value-oriented strategies outperformed the market meaningfully as the valuation differential between growth and value continued to narrow. Investors remained focused on fundamentals as the economy improved, which enabled value to outperform growth through 2006.

Equity markets experienced another significant bifurcation from mid-2014 to early 2016, with large-cap growth stocks again outperforming small- and mid-cap value stocks. Two major macro factors triggered this equity market divergence: firstly, a rapid and sustained decline in commodity prices, highlighted by a historic 70% peak-to-trough decline in the price of oil; and secondly, a similarly rapid and sustained strengthening of the US dollar, which appreciated by 25% to 40% against major developed market currencies, and by 40% to 80% against many emerging market currencies. These two disruptions caused fear among investors and pressured the earnings of US industrial and export-focused companies, prompting investors to rotate back to large-cap stocks at the expense of small- and mid-caps, and to growth and momentum at the expense of value stocks. Passive investing, already on the rise for years due to substantial capital inflows into ETFs, gained even more momentum during this period, exacerbating the bifurcation. The so-called FANG stocks (Facebook, Amazon, Netflix and Google) gained more than 80% on average in 2015, largely due to a multiple expansion in valuations, fuelling a double-digit gain in the Nasdaq 100 Index, which, without these four stocks, would have been down in 2015.

It would seem to us that the multi-year rotation away from value may be in the process of reversing after equity markets experienced their worst start to any year on record. This sell-off was broad based, but as investors once again fled to the relative 'safety' of mega-cap consumer staple and growth stocks, small- and mid-cap stocks and many value stocks were disproportionately impacted, driving valuations to near historically low levels. The bottom in February 2016 and subsequent recovery of the equity market might have coincided with another major inflection point in the dynamic from growth to value. This inflection point appears to be a function of the stabilisation of the two macroeconomic factors (oil prices and the US dollar) that drove the recent bifurcation in equity markets: oil prices have rebounded significantly from their low, and the US dollar has gradually stabilised against major currencies.

Walgreens Boots Alliance

A compelling investment opportunity.

by **STEVEN BARBER**

__STEVEN BARBER__ is an analyst in the global developed markets team. He joined Coronation in 2012, prior to which he was an analyst at Element Investment Managers.

The global pharmacy giant Walgreens Boots Alliance (WBA) recently made headlines with its plans to create the largest pharmacy chain in the US through the acquisition of its competitor Rite Aid.

We have found compelling investment value in WBA for some time, and have built a sizeable holding across some of our funds. Even without the Rite Aid transaction, the company offers a high-quality investment that is trading below our assessment of its intrinsic value, and which should see substantial operational gains over the long term.

Background

Following the two-stage acquisition of Alliance Boots by Walgreens, WBA was formed in December 2014.

The new group has three principal divisions:

Retail Pharmacy USA (75% of group profits): Walgreens is the second largest US retail pharmacy chain with over 8 000 locations across the US.

Retail Pharmacy International (15% of group profits): Boots, the retail pharmacy chain with 2 500 stores across the UK, is the primary contributor to this division's profits. This business is fairly mature and has attractive levels of profitability.

Pharmaceutical Wholesale (10% of group profits): Alliance Healthcare is a pan-European pharmaceutical wholesale business that operates distribution centres throughout Europe, delivering drugs to pharmacies and hospitals. This business is also mature and has the low margins typical of a wholesaler.

Management

While on paper Walgreens acquired Alliance Boots, the deal has the hallmarks of a reverse takeover. Upon consummation of the deal, the Alliance Boots management team, led by the Italian Stefano Pessina, assumed leadership of the combined entity. We rate Pessina and his team as one of the best in our investment universe. Pessina has a unique strategic vision and is a patient and disciplined dealmaker, with an incredible track record of value creation over almost 40 years through both mergers and acquisitions (M&A) and operational turnarounds. In 1977 he took over his family's small, struggling Italian pharmaceutical wholesaler. Since then he has concluded over 500 M&A deals[1], first building a pan-European pharmaceutical wholesaler, and subsequently a retail pharmacy business focused primarily on the UK and the US. Notable deals include:

- a merger with the French pharmaceutical wholesaler Santé in 1991;
- a merger with the UK pharmaceutical wholesaler Unichem in 1997;
- a merger with Boots in 2006 and the delisting of Alliance Boots in 2007 in partnership with KKR;
- a merger with Walgreens in a two-step transaction (2012, 2014); and
- the possible acquisition of Rite Aid, the third-largest US pharmacy chain (awaiting Federal Trade Commission approval).

[1] *The number could be as high as 1 500 but because many of the deals were concluded in unlisted entities it is not possible to verify the actual number.*

Today, Pessina owns a 13% stake in WBA worth $12 billion. He is self-avowedly a dealmaker: "I am not a retailer – I have never run a store, I have never understood the full details of how you can make a consumer satisfied … To build a company, to do deals, to motivate people: this is what I am able to do." He has assembled a formidable team under him, led by Alex Gourlay (head of Walgreens and Boots) and Ornella Barra (head of Alliance Healthcare). The team that is now running Walgreens is the same one that achieved phenomenal success transforming Boots in the UK. Between 2006 and 2014, in a very tough revenue environment (revenues per script declined 16% due to reimbursement[2] cuts by the NHS), profit margins increased from 7.6% to 12.4% and profits almost doubled. This is largely attributable to cost savings, and a wildly successful health and beauty strategy built around the Boots No7 brand.

The opportunity at Walgreens

We believe that the fundamental backdrop at Walgreens is favourable:

- The ageing US population – 10 000 people a day are turning 65 and becoming eligible to join Medicare[3] – should continue to drive low single-digit growth in scripts as the elderly consume significantly higher volumes of pharmaceuticals than younger generations.
- Ongoing generic conversions[4] should continue to support profitability. While some 85% of scripts dispensed in the US are already generics, the generic conversion pipeline over the next few years should provide a tailwind to pharmacy profitability. Pharmacies earn higher profits on generic drugs than they do on branded alternatives.
- Following a brief period of generic inflation over the last few years due to disruptions in the generic supply chain and a backlog of new generic approvals by the US Food and Drug Administration (FDA)[5], generics have more recently resumed their typical deflationary trend. This will support pharmacy profitability.

Offsetting these tailwinds is ongoing reimbursement pressure. There is no shortage of pharmacies in the US and as they all compete to grow script volumes, there is a general downward trend in the level of reimbursement paid to them. We believe that Walgreens is reasonably well positioned in this environment. As one of two 'at scale' pharmacy chains, they are best positioned to leverage their size to trade lower reimbursement for higher script volumes. Given the fixed-cost nature of pharmacy operations, if done correctly, this trade-off can deliver positive results as more scripts flow through the store network. The new management team is also well versed in operating in the UK's intense reimbursement environment and should be able to offset headwinds through efficiencies and cost savings.

We believe that under the leadership of Pessina there are substantial opportunities to improve the operational performance of what we believe was an undermanaged business. (Pessina is the first external CEO appointment at Walgreens in more than 100 years!) Margins are considerably lower than its closest peer, CVS. There is now a clear strategy to grow script market share, cut costs and improve the mix in the front-end of their stores.

There are early signs of success evident at Walgreens, with substantial cost savings and merger synergies already delivered. The longer-term opportunity lies in continued operating efficiency improvements and transforming the health and beauty offering at Walgreens by implementing some of the learnings from Boots. This is a longer-term opportunity that will take time to deliver results.

The pending Rite Aid acquisition

WBA is in the process of acquiring Rite Aid, the third-largest stand-alone US retail pharmacy chain with approximately 4 500 stores. We believe that the deal makes both financial and strategic sense and that WBA is acquiring Rite Aid at an attractive price. The Rite Aid store base has a complementary geographic footprint with Walgreens and will in effect 'complete' the Walgreens store base, giving it a nationwide footprint.

Rite Aid has been challenged as a stand-alone business and its margins are half those of Walgreens. Significant debt incurred prior to the 2009 financial crisis and the associated

[2] *Reimbursement is the term used to refer to the amount that a pharmacy is paid for dispensing a script. In the UK, the NHS is the sole payer, whilst in the US pharmacies negotiate reimbursement with the pharmacy benefit managers.*

[3] *Medicare is the US government healthcare plan for those 65 and older.*

[4] *The process whereby a branded pharmaceutical drug loses patent protection and has to compete with generic copies of the drug, normally sold at a fraction of the price of the branded drug.*

[5] *The regulatory entity that oversees the pharmaceutical industry.*

cash flow constraints have constrained management's ability to run the business optimally. In addition, Rite Aid's lack of scale relative to its two larger peers has rendered it less competitive when negotiating reimbursement and in pharmaceutical procurement. We believe that by combining with WBA, there are significant synergies that WBA can unlock by using its superior size to negotiate better procurement and reimbursement terms.

The deal is not without challenges. It is subject to approval from the Federal Trade Commission, which may still block the deal on anticompetitive grounds. We believe anticompetitive concerns can be assuaged through manageable store divestitures. WBA has confirmed that it is willing to dispose of up to 1 000 stores, but there remains a risk that the deal does not get approved.

Another challenge is that the Rite Aid store base is underinvested and in poorer locations than rivals Walgreens and CVS. WBA will have to invest in the store base to bring it up to acceptable standards.

While we believe the acquisition of Rite Aid offers a compelling opportunity to create sustainable value, we believe that WBA is an attractive investment with or without Rite Aid, and our investment case is not premised on the Rite Aid deal.

Mexico

A local bank is our top investment holding in a promising market.

by **IAKOVOS MEKIOS**

__IAKOVOS MEKIOS__ is an analyst in the global emerging markets team. He joined Coronation in 2013, prior to which he was an investment consultant at Willis Towers Watson in London.

Coronation investment team members recently visited Mexico where we gained an on-the-ground view of the country's prospects and a better understanding of what some of its most dynamic companies are planning. We met one-on-one with a number of key executives and visited operations in the consumer and financial sectors.

In the past, we have been fairly cautious on the Mexican market. Generally, it trades at higher-than-average multiples compared to the rest of the Global Emerging Market (GEM) universe. Also, while its economy is often touted as being close to an inflection point, Mexican growth has been a perennial disappointment. While valuations in Mexico remained stretched (its stock market is currently trading at around 18.4 times one-year forward earnings versus 12 times for the broader GEM universe), we believe that its economic fundamentals as well as various policy initiatives have at last created a more conducive environment for select medium- to long-term investment opportunities. Mexico has either already implemented, or is in the process of implementing, a series of reforms in education, energy, banking and the fiscus – arguably, the most ambitious policy reform programme in our GEM universe.

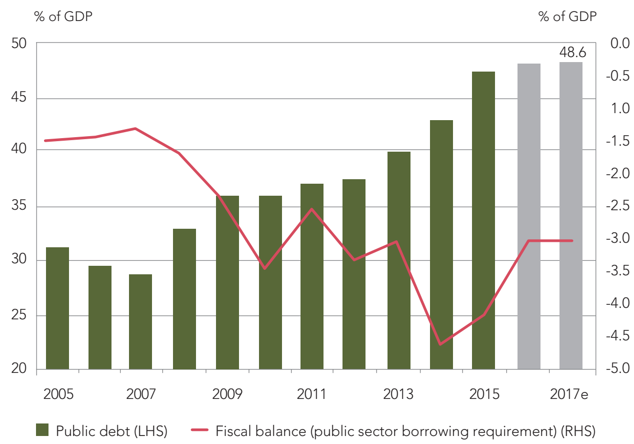
Still, we have found a clear disconnect between the respective outlooks of policymakers and company management teams. Policymakers are increasingly defensive in their policy mix. However, management teams appear optimistic about the demand outlook for their businesses, especially those facing the consumers. This is largely due to the boom that most Mexican consumers have been enjoying. Employment stands at its highest level in years (with an unemployment rate of 3.9%) and remittances (mostly from Mexicans living in the neighbouring US) have grown 28% in Mexican peso in the year to date. Although the sanguine mood of the policymakers has been tempering consumer sentiment, which remains at moderate levels, consumer spending and credit are nonetheless growing at a healthy pace. Accordingly, banks are seeing strong growth in the demand for consumer loans and the use of credit cards, and a number of retailers are enjoying robust same-store sales growth. This sector (in particular segments such as convenience stores, food retail and casual dining) is also benefiting from the shift from informal trading to formal, more sophisticated outlets. Mexico has a much larger informal sector than many other emerging countries, with strong scope for growing formalisation.

Mexico's competitiveness has improved significantly in the years since the global financial crisis. As labour productivity in China has been declining, Mexico has benefited from the decision of large manufacturing companies to resettle their activities closer to the important end-user market of the US. It has also continued to see a flow of US manufacturing capacity moving across the border to take advantage of its stronger economic growth, lower cost of labour and convenient location. More recently though, as the strong dollar and low oil price weighed on US manufacturing orders, Mexico has also seen a slowdown in its own manufacturing sector (as much of it is intricately linked to US supply chains).

The challenges that Mexican policymakers face are not negligible. In the last six months, the Mexican central bank (Banxico) has had to raise its benchmark rates by a total of 125 basis points in order to shore up support for the peso, which has seen a steady decline since the end of 2014. The currency's high liquidity and low yield make it an easy proxy for investors who want to take a short position in emerging market currencies, a popular trade the last couple of years. The authorities have adopted more stringent fiscal measures to bolster state revenues and to counter the effect of low oil prices on the external accounts. (While oil and gas are not as material for Mexico as they are for some of its Latin American peers, the country is a net exporter of oil.) The timing of liberalisation of the energy industry (previously monopolised by troubled state giant Pemex) has been unfortunate: it came amid collapsing commodity prices, resulting in lower-than-expected revenues from oil field auctions. The result has been a widening in the country's twin deficits (fiscal and current account), an additional source of vulnerability for the peso. Although foreign direct investment has continued to increase, the economy has grown more vulnerable to external crises and the currency has played the role of the shock absorber.

Of course, it should be underlined that given the linkages of the Mexican economy to its wealthy northern neighbour, it is important for the country's economic performance that US growth remains at least benign. Also, the possible election of Donald Trump (who has adopted a hostile stance towards Mexico) as US president is a risk. In addition, prospective investors need to take note of the early signs of a rise in domestic Mexican populism.

MEXICO'S PUBLIC FINANCES SHOULD STABILISE



Sources: Mexican Ministry of Finance, Barclays Research

A number of Mexican companies, particularly in the consumer sector, are on our radar. These include Femsa, a Mexican-based multinational which (among other businesses) owns the country's largest beverage bottling company, as well as the leading convenience store chain Oxxo and a 20% interest in the brewer Heineken NV. We also like Alsea, which operates fast-food and casual-dining brands in Mexico, broader Latin America and Spain. However, we believe their valuations are too demanding, and we are happy to remain patient and buy them only when the price is right. While the Coronation GEM Fund holds a small position in the US-listed railways operator Kansas City Southern for its Mexican exposure (Mexico represents more than half of the group's profits), the fund currently only has one Mexican-listed holding: Grupo Financiero Banorte.

Banorte

We have been investors in Banorte since November 2014. Banking represents some 70% of its earnings, while long-term savings (insurance and asset management) make up 22%, followed by brokerage (5%) and its other activities (3%). Over recent years, the group's profitability has been underwhelming due to a long period of record-low interest rates (which squeezed its net interest margins), the cost of integrating Ixe Banco (which focuses on the premium segment and had a high cost base) after its acquisition in late 2010 and low levels of leverage. A relatively new management team has embarked on initiatives to improve the utilisation of the bank's balance sheet. The team wants to achieve a return on equity (ROE) target of 20% by the end of the decade – and, importantly in our view, management is aligned to this target. Some 40% of executives' variable compensation will only be released as key ROE milestones are achieved.

We believe the ROE target will be achieved due to the following:

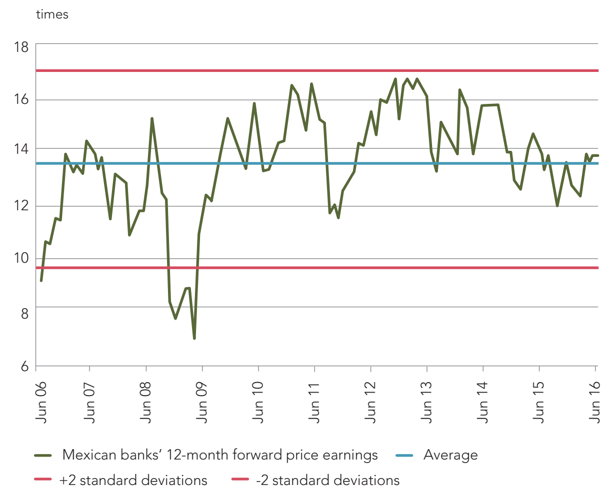
- The implementation of efficiency initiatives. These interventions are in the process of being adopted following an extensive consulting project, led by IBM. The initiatives include a new customer relationship management system, expanded use of online and mobile channels, and the optimisation of the bank's fee and commission structure. In the next five years, the bank's branch footprint will remain stable or grow smaller, while its assets are forecast to continue growing by double digits.
- A return of capital to shareholders. This could come in the form of larger ordinary dividends and, potentially, the payment of extraordinary dividends.

- Material improvements in the cross-selling of products to the bank's existing customers. The bank has already seen some success on this front: the number of products sold per customer has increased from 1.7 to 1.83 products since the management team set on improving this metric. It believes this can grow to more than two products.
- A key shift in its client base. The breakdown of Banorte's various customer segments is stunning: high-income customers represent 1% of its total number of customers, but provide 12% of profits, while middle-income customers are 4% of total and contribute 65% of profits! By comparison, 95% of its customers are low-income and generate 23% of profits. Management believes that 40% of the low-income customers are moving into the middle-income segment – this could present the bank with a big opportunity.
- Rising interest rates. Banorte is one of the most asset-sensitive banks in the country (meaning its assets re-price considerably faster than its liabilities) and will benefit from higher net interest income as the central bank of Mexico increases its policy rate.
- An increase in the contribution to earnings from the non-banking subsidiaries of the group, especially insurance and pension management. Both stand to benefit from structural tailwinds and are high ROE businesses.

In terms of competition, Banorte (which has the fourth-largest share of the loan market), along with other players, are taking market share off the embattled Banamex (the number two player, owned by Citigroup). While competition is robust, generally product pricing remains rational, as we understand from our conversations with a number of management teams in the sector.

While we believe Banorte offers a strong investment case, governance risk has deterred investors over the past two years. Banorte's chairman Carlos Hank González is the former CEO and majority shareholder of Grupo Financiero Interacciones. His family holds a stake of more than 70% in this Mexican financial institution, which is mostly focused on infrastructure loans. Investors were concerned that he might attempt to force a merger between the two companies, to the detriment of Banorte's minority shareholders. However, Hank González has repeatedly denied this. Last month, he backed this up with more concrete action. He suggested a change in the company's bylaws that will ensure that any acquisition proposal for a related party (e.g. Grupo Interacciones) has to be approved not only by Banorte's audit and corporate practices committee and the board, but also be put to a shareholder vote. This should allay any lingering corporate governance concerns.

VALUATIONS OF MEXICAN BANKS



Sources: MSCI Aggregates, Thomson Financials Datastream, UBS

From a valuation point of view, Mexican banks in general look rather pricey compared to their emerging market peers. However, compared to their own history, valuations are in line with the average forward price earnings multiple over the past ten years. The banks are also trading below their average price-to-book levels over the same time period. Banorte has appreciated nicely since our initial purchase. It can currently be bought for approximately 14 times one-year forward earnings or 1.8 times book value – reasonable, given the robust earnings growth we expect in the coming years. Accordingly, Banorte remains a holding of the Coronation GEM Fund.

Nigeria: Addicted to dollars

An investment response to naira uncertainty.

by **GREG LONGE**

***GREGORY LONGE** is an investment analyst in Coronation's Global Frontiers unit. Gregory is a Chartered Accountant (SA) and joined Coronation in 2013 after completing his articles at Ernst & Young.*

Addiction. A word that can conjure up a multiplicity of emotions, including euphoric highs and heart-breaking failures. Whether we care to admit it or not, in some way most of us are addicted to something: love, work, social media, alcohol, coffee, status or food. Some 'substances' may be more socially acceptable than others, and in measured doses, some of these addictions may be good for us, but there comes a point where we develop an unhealthy reliance on our vice of choice. Take that stimulant away and we slowly fall apart.

Nigeria is addicted to dollars. Over the past 18 months, the government has had to figure out how best to respond to much less of its regular hit.

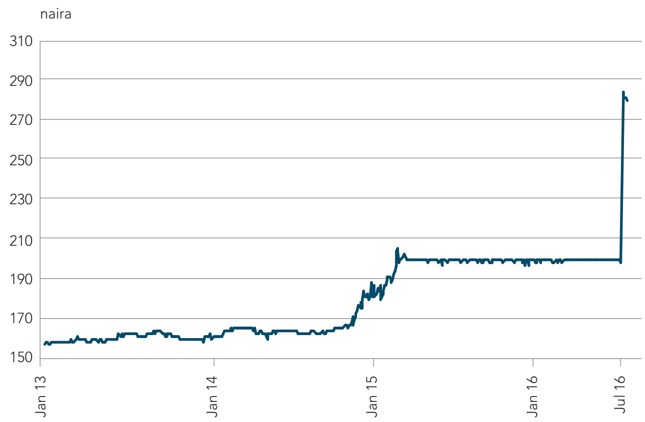
Nigeria, like other oil producers, is deeply reliant on oil revenue. Not only does oil account for more than 80% of its fiscal revenue, but with oil representing close to 90% of exports, it is effectively its only source of dollar income. These dollars are then used to pay for Nigeria's large import bill. The import bill is large because Nigeria produces very little locally. A steady stream of dollars is thus vital to ensure that the population is fed, clothed and able to move around. It is also vital to ensure that businesses can access raw materials and the equipment that they need to function. With the collapse in oil prices, and cut off from dollars, Nigeria's economy has become deeply strained. The impact of going cold turkey has been harsh: the current account fell into a deficit of -3.3% of GDP, the first deficit in 13 years; the trade balance turned negative for the first time in 30 years; and oil-related foreign direct investment collapsed.

Nigeria's economic fundamentals saw a meaningful deterioration, but unlike other oil producers that allow their currencies to weaken, Nigeria's policy response was to hold the naira painfully stable, resulting in a very overvalued currency. Government contended that fixing the currency would limit the impact of inflation on the economy and protect the poor from rising food prices. Unfortunately, it effectively led to a seizure in the foreign exchange market and many businesses were forced to buy dollars through unofficial channels, where rates were 50% to 100% higher than the official rate. This meant that inflation rose regardless. In order to hold the pegged exchange rate, the Central Bank of Nigeria (CBN) implemented an array of restrictions, including a long list of import controls. This forced even more businesses into the unofficial market. The net result has been a sharp rise in inflation and a decline in growth. Inflation was 15.6% year-on-year in May and GDP growth in the first quarter of 2016 was -0.4% year-on-year and is forecast to contract almost -2% in real terms for the year as a whole.

BRENT CRUDE OIL PRICE

Source: Bloomberg

NAIRA / DOLLAR EXCHANGE RATE



Source: Bloomberg

The cost of defending the naira finally became too much to bear and the currency was allowed to float in June. We view this as a positive development, as we believe that the level of the exchange rate is far less important than the requirement for dollars to be accessible in the market. Businesses are surprisingly resilient and are generally able to deal with a sharp rise in costs, either through passing on price increases, cutting costs or accepting lower margins. However, resilient businesses cannot survive if the raw materials or machinery they need to produce their products suddenly become unavailable. This is what happens when they cannot access dollars; businesses that rely on imported raw materials grind to a halt. Assuming the CBN allows the naira to find a rate that fully reflects its real market value in coming months, the economy is likely to go through a painful, but necessary, adjustment. The first impact will be higher inflation in an environment where prices are already rising.

We would expect the CBN to respond by increasing the monetary policy rate by some 200 to 300 basis points over the next year. At the same time, the external balance should adjust, providing some reprieve and better support for growth. A currency that is completely free-floating and that is more reflective of fundamentals should support confidence in not only the value, but also the convertibility, of the currency.

Admittedly it is still early days in the new regime, but our initial euphoria over Nigeria's move towards a freer exchange rate is waning. Liquidity has continued to be severely constrained and the rate of exchange has been stubbornly steady around N280 to the dollar. The market remains opaque, with limited visibility into its inner workings. An obvious question at the moment is whether Nigera has truly moved to a floating exchange rate or whether the CBN is managing the float, allowing for a one-off 40% devaluation, but now continuing to maintain the peg, albeit at a lower level. The risk with a 'managed float' is that the underlying problem (dollar shortages in the economy) is not addressed and the limited access to dollars will ultimately strangle the economy once again.

As the manager of an Africa-focused fund, it is difficult to ignore a country like Nigeria, and over the medium to long term, we still believe that Nigeria is one of the most attractive markets globally. Unsurprisingly, we have seldom struggled to find high-quality companies trading at attractive valuations on the Lagos bourse. However, given the policy response of president Muhammadu Buhari's administration to the decline in oil prices, we have spent the better part of the last 18 months debating how best we should respond in our portfolios.

At this point, it is worth noting that our investment methodology is very much a long-term, bottom-up, valuation-driven one. Exchange rates and currencies are taken into account in our earnings forecasts, but are viewed admittedly as 'low-conviction' inputs. We simply have never been very good at calling short-term fluctuations in currencies. Our competitive advantage is our long-term investment horizon and our valuation-driven philosophy, not our view on a particular currency. With that caveat out of the way, how did we position ourselves?

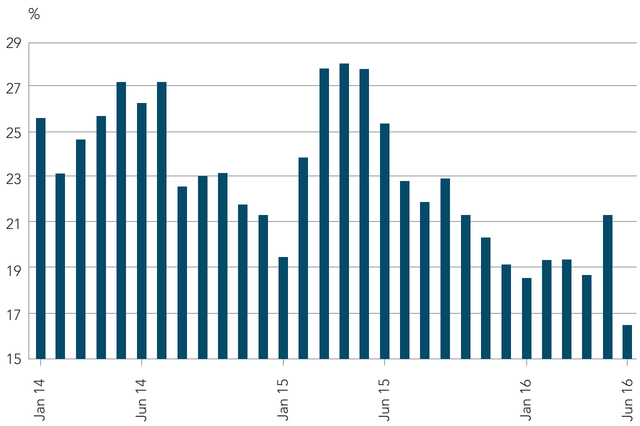
Our approach was as follows:

Reduce our position size

As the oil price started falling in the second half of 2014, equity valuations began to look stretched and our earnings forecasts started to decline. We took a decision to reduce our Nigerian exposure from a high of 27.4% of our Africa Frontiers Fund in July 2014 to 19.6% in January 2015.

Following the move to reduce our exposure to Nigeria, the market sold off significantly in the run-up to the March 2015 election. With valuations looking attractive, we added to some of our positions, increasing our Nigeria exposure, resulting in Nigeria once again representing 27% of fund. This investment allowed us to benefit from the strong market gains following the peaceful transition to the Buhari administration. The large market gains pushed some of our holdings to close to our estimate of their fair value. Accordingly, we reduced our portfolio exposure to below 20% once again. At the time, there were still enough dollars in the market to enable this withdrawal and we could repatriate our naira sales. We also increased our cash holding at this time.

CORONATION AFRICA FRONTIERS FUND'S EXPOSURE TO NIGERIA



Source: Coronation

Hedge the naira

In November 2014, with oil prices continuing to fall rapidly and the naira stubbornly pegged at N168 to the dollar, we entered into a hedge for 20% of our Nigerian exposure. This allowed us to further reduce our naira position without having to physically sell the underlying shares. In hindsight, while the hedge worked very well for us, we should have hedged a far greater proportion of our exposure.

Switch exposure to foreign listings

As dollar liquidity in the market dried up in the second half of 2015 and concern grew around our ability to repatriate returns from any sales, we took an active decision to move our exposure in dual-listed companies from listings on the Lagos exchange to the equivalent listings in London or New York. This allowed us to continue to trade these shares without worrying whether the de facto capital controls in Nigeria would persist.

Avoid cash

Over the course of 2016, it became apparent that it would be very difficult to repatriate any naira into dollars. We were effectively stuck with the naira we had invested in Nigeria. While we waited for the inevitable devaluation, the very worst place to be would be in cash. Any devaluation would see the fund take a guaranteed loss. A far better place to hide was in equities, which we expected would see a relief rally following any currency move.

Avoid companies that short dollars

The final adjustment to our portfolios was to switch out of companies that were naturally shorting dollars or were exposed to the Nigerian consumer, and buy companies that stand to benefit from a naira devaluation. This saw us sell out of a number of counters that have dollar payables or have large import bills. A company that we have been adding to in this environment is Dangote Cement. Dangote is commissioning cement plants across the continent, resulting in dollar revenues increasing as a percentage of its sales. Any naira devaluation would benefit Dangote, as the company earns 30% of its revenue from international operations, cushioning any rising import costs.

Whether Nigeria will learn from the latest oil shock and pursue more appropriate policy responses going forward is yet to be seen. The Buhari government has certainly taken a step in the right direction by allowing the naira to float and we believe that their intentions are good. However, good intentions, as any addict knows, are largely worthless. What Nigeria needs is for the currency to float freely and for a market-determined exchange rate to attract an inflow of dollars once again.

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]	92.9% / 7.1%	60.9% / 39.1%	44.6% / 55.4%	14.6% / 85.4%	0.2% / 99.8%
LAUNCH DATE	Jul 2001	Mar 2007	Jul 2001	Apr 1996	Oct 2000
ANNUAL RETURN (Since launch)	**10.6%** †7.9%	**10.7%** †6.4%	**13.3%** †6.1%	**15.8%** †14.0%	**19.7%** †15.3%
QUARTILE RANK (Since launch)	1st	1st	1st	1st	1st
ANNUAL RETURN (Last 10 years)	**9.3%** †7.1%	**–** –	**11.0%** †6.3%	**13.0%** †12.3%	**14.7%** †12.3%
QUARTILE RANK (Last 10 years)	1st	–	1st	1st	1st
ANNUAL RETURN (Last 5 years)	**8.9%** †5.6%	**11.6%** †5.8%	**10.7%** †5.8%	**13.8%** †13.8%	**12.9%** †13.9%
QUARTILE RANK (Last 5 years)	1st	1st	2nd	1st	2nd
STANDARD DEVIATION (Last 5 years)	**1.6%** †0.2%	**4.1%** †1.4%	**5.6%** †1.4%	**7.8%** †7.4%	**13.2%** †12.4%
FUND HIGHLIGHTS	Outperformed cash by on average 3.3% p.a. over the past 5 years and 2.8% p.a. since launch (after fees). Note that outperformance is expected to be less in periods of stable or rising interest rates.	Outperformed inflation by 4.2% p.a. (after fees) since launch, while producing positive returns over 12 months 100% of the time. A top performing conservative fund in South Africa over 5 years.	Outperformed inflation by 7.3% p.a. (after fees) since launch, while producing positive returns over 12 months more than 90% of the time.	No. 1 balanced fund in South Africa since launch, outperforming its average competitor by 2.5% p.a. Outperformed inflation by on average 8.5% p.a. over all rolling 5-year periods since launch.	The fund added on average 4.4% p.a. to the return of the market. This means R100 000 invested in Top 20 at launch grew to more than R1.6 million by end-June 2016 – nearly double the current value of a similar investment in the FTSE/JSE Top 40 Index.

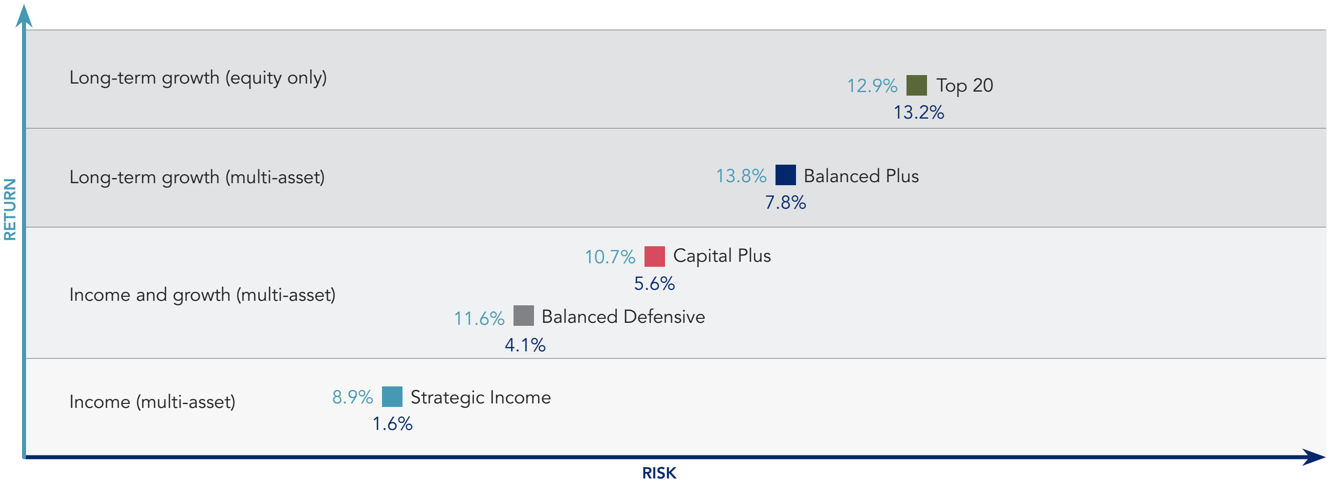
▪ Income ▪ Growth

1. Income versus growth assets as at 30 June 2016. Growth assets defined as equities, listed property and commodities.

Figures are quoted from Morningstar as at 30 June 2016 for a lump sum investment and are calculated on a NAV-NAV basis with income distributions reinvested.

Risk versus return

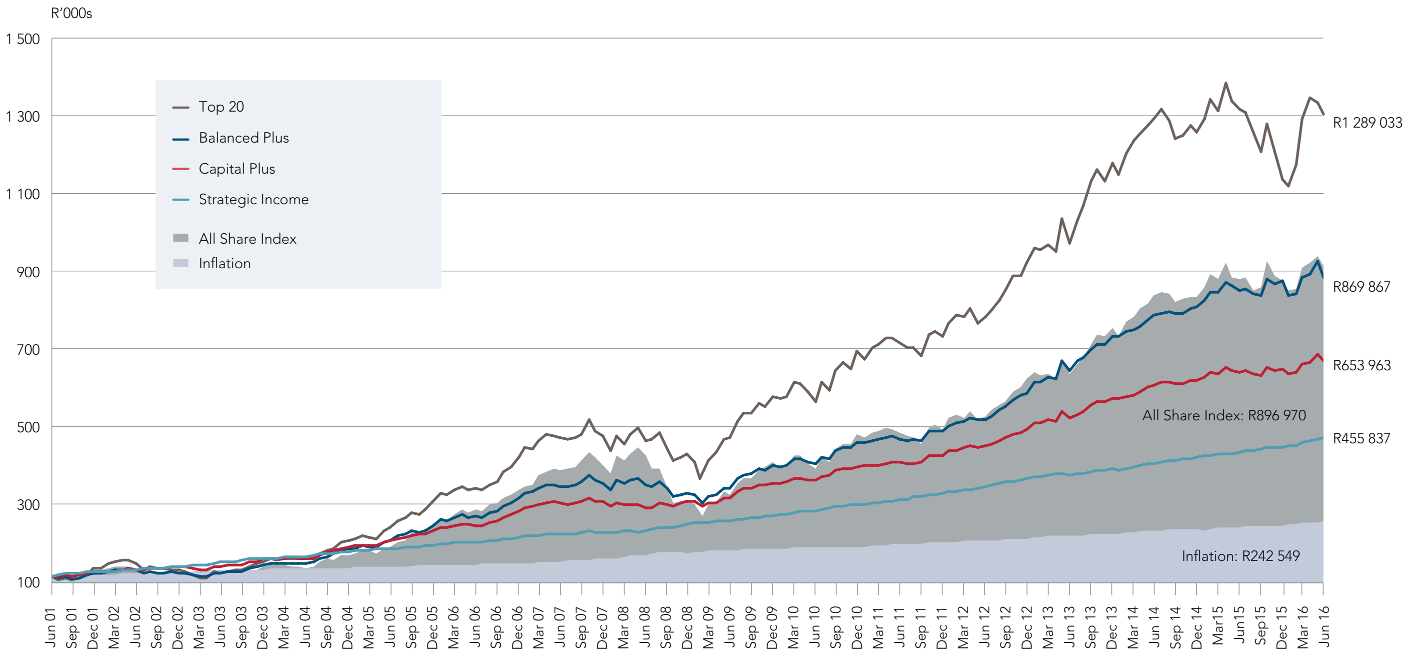
5-year annualised return and risk (standard deviation) quoted as at 30 June 2016. Figures quoted in ZAR after all income reinvested and all costs deducted.



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 2016. 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*** 110% of 3-month Libor†	**Global Capital Plus [ZAR] Feeder** ***Global Capital Plus [foreign currency]***[4] Global cash (100% USD)†	**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]	97.9% / 2.1%	52.3% / 47.7%	23.9% / 76.1%	1.3% / 98.7%	1.0% / 99.0%
LAUNCH DATE	Aug 2013 *Dec 2011*	Sep 2008 *Sep 2009*	Oct 2009 *March 2010*	Aug 1997 *May 2008*	Dec 2007 *July 2008*
ANNUAL RETURN[3] (Since launch)	**1.4%** †0.4%	**5.4%** †(0.1%)	**5.8%** †6.3%	**6.1%** †5.1%	**0.5%** †(2.0%)
QUARTILE RANK (Since launch)	4th	1st	1st	1st	2nd
ANNUAL RETURN (Last 5 years)	**–** –	**1.6%** (2.0%)	**4.0%** 4.8%	**5.4%** 7.2%	**(2.6%)** (3.5%)
QUARTILE RANK (Last 5 years)	–	2nd	1st	1st	4th
FUND HIGHLIGHTS	Outperformed US dollar cash by 2.44% (after fees) since launch in December 2011.	The houseview currency class of the fund has outperformed its cash benchmark by 5.4% p.a. since launch.	No. 1 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. Outperformed the global equity market at less than market risk.	Both the rand and dollar versions of the fund have outperformed the MSCI Emerging Markets Index by more than 2.0% p.a. since their respective launch dates.

▪ Income ▪ Growth

1. Rand and dollar-denominated fund names are included for reference.
2. Income versus growth assets as at 30 June 2016. Growth assets defined as equities, listed property and commodities.
3. Returns quoted in USD for the oldest fund.
4. Available in USD Hedged, GBP Hedged, EUR Hedged or Houseview currency classes.

Figures are quoted from Morningstar as at 30 June 2016 for a lump sum investment and are calculated on a NAV-NAV basis with income distributions reinvested.

Collective Investment Schemes in Securities (unit trusts) are generally medium- to long-term investments. The value of participatory interests (units) may go down as well as up and past performance is not necessarily an indication of future performance. Participatory interests are traded at ruling prices and can engage in scrip lending and borrowing. Fluctuations or movements in exchange rates may cause the value of underlying investments to go up or down. A schedule of fees and charges is available on request from the management company. Pricing is calculated on a net asset value basis, less permissible deductions. Forward pricing is used. Commission and incentives may be paid and, if so, are included in the overall costs. Coronation is a member of the Association for Savings and Investment SA (ASISA).

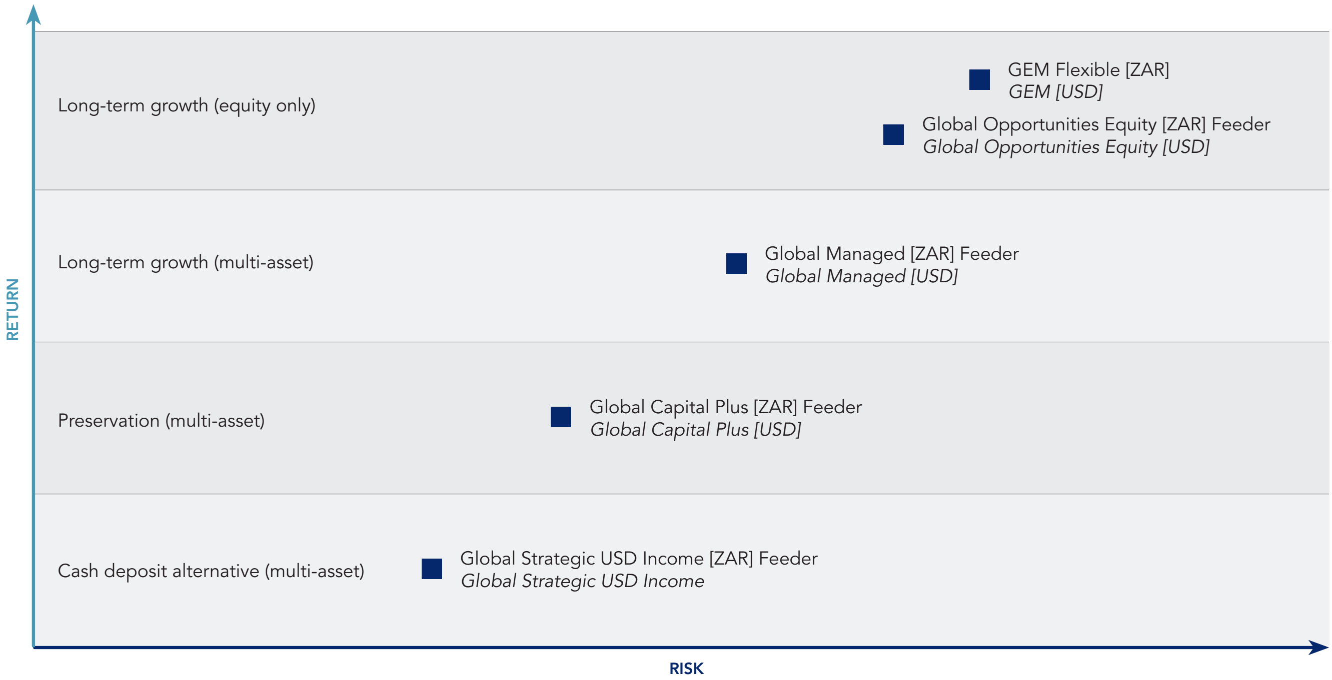
HAVE YOU CONSIDERED EXTERNALISING RANDS? IT'S EASIER THAN YOU MIGHT THINK.

The SARB allows each resident South African taxpayer to externalise funds of up to R11 million per calendar year (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 SARS 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 that 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.

Expected risk versus return

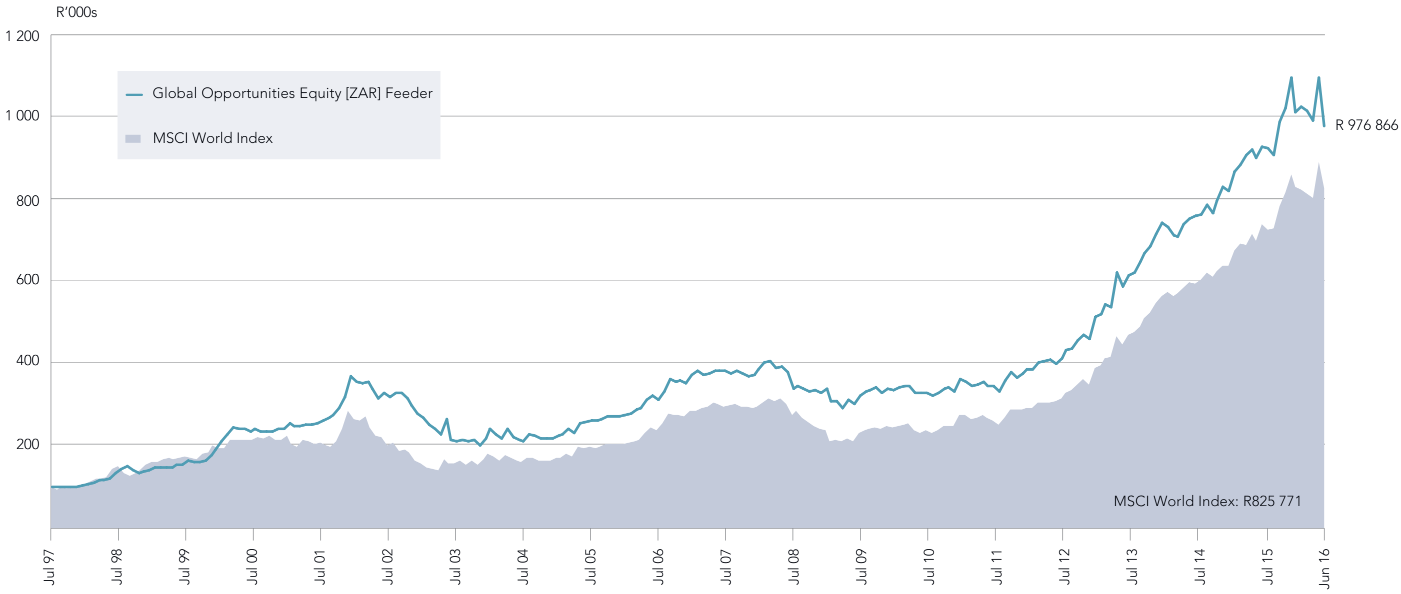
Expected return and risk positioning for both rand- and dollar-denominated funds after all income reinvested and all costs deducted.



Source: Morningstar

Growth of R100 000 invested in Global Opportunities Equity [ZAR] Feeder on 1 August 1997

Value of R100 000 invested in Global Opportunities Equity [ZAR] Feeder on 1 August 1997 as at 30 June 2016. All income reinvested for funds; MSCI World Index is on a total return basis. Global Capital Plus [ZAR] Feeder, Global Emerging Markets Flexible [ZAR], Global Managed [ZAR] Feeder and Global Strategic USD Income [ZAR] Feeder, which were launched between 2007 and 2012, have not been included.

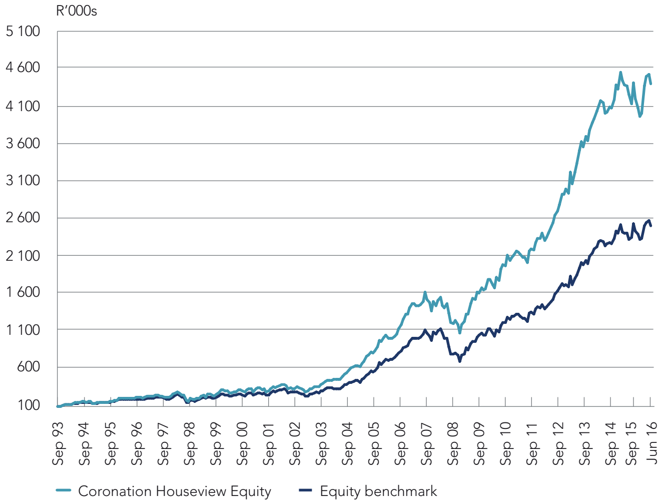


Source: Morningstar

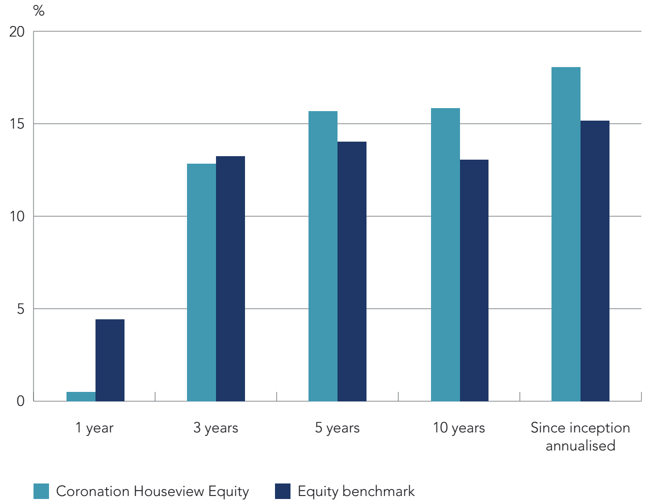
CORONATION HOUSEVIEW EQUITY* RETURNS VS EQUITY BENCHMARK

5-YEAR ANNUALISED RETURNS	CORONATION HOUSEVIEW EQUITY	EQUITY BENCHMARK	ALPHA
1998	8.15%	6.49%	1.66%
1999	14.23%	10.91%	3.33%
2000	10.93%	7.52%	3.41%
2001	10.95%	9.38%	1.57%
2002	9.46%	7.80%	1.66%
2003	18.02%	13.78%	4.24%
2004	14.12%	9.63%	4.49%
2005	23.35%	18.94%	4.41%
2006	28.38%	23.66%	4.72%
2007	33.79%	29.55%	4.24%
2008	23.36%	19.73%	3.63%
2009	22.23%	20.67%	1.56%
2010	18.55%	15.73%	2.82%
2011	11.58%	8.73%	2.85%
2012	13.39%	10.10%	3.29%
2013	24.37%	20.21%	4.16%
2014	19.39%	16.08%	3.31%
2015	14.05%	13.14%	0.91%
4 years 6 months to 30 June 2016	16.83%	15.16%	1.67%
ANNUALISED TO 30 JUNE 2016			
1 year	0.44%	4.45%	(4.01%)
3 years	12.87%	13.27%	(0.40%)
5 years	15.64%	14.09%	1.55%
10 years	15.91%	13.08%	2.83%
Since inception in October 1993 annualised	18.10%	15.22%	2.88%
Average outperformance per 5-year return			3.05%
Number of 5-year periods outperformed			19.00
Number of 5-year periods underperformed			-

CUMULATIVE PERFORMANCE



ANNUALISED RETURNS TO 30 JUNE 2016



An investment of R100 000 in Coronation Houseview Equity on 1 October 1993 would have grown to **R4 402 215** by 30 June 2016. By comparison, the returns generated by the Equity Benchmark over the same period would have grown a similar investment to **R2 511 159**.

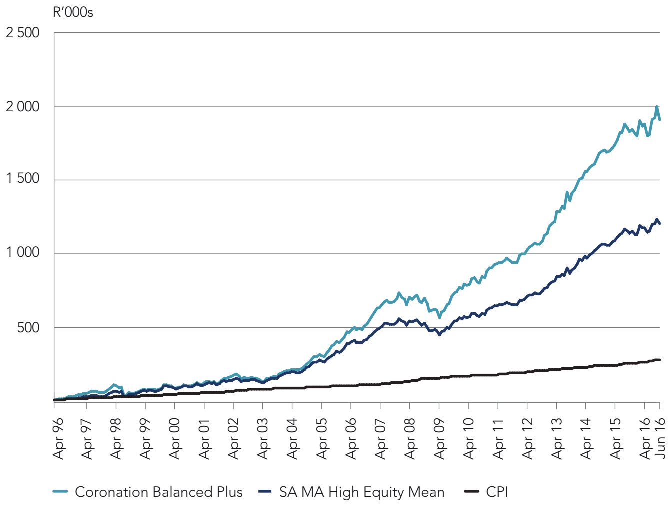
* *Coronation Houseview Equity, which is an institutional portfolio, has been used to illustrate Coronation's investment track record since inception of the business in 1993.*

CORONATION BALANCED PLUS FUND VS INFLATION AND AVERAGE COMPETITOR†

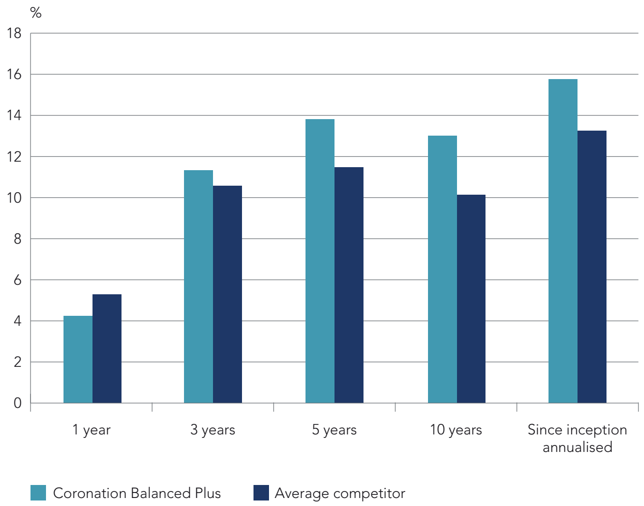
5-YEAR ANNUALISED RETURNS	CORONATION BALANCED PLUS	INFLATION	REAL RETURN
56 months to 31 December 2000	16.00%	7.90%	8.10%
2001	14.38%	7.41%	6.97%
2002	10.73%	8.04%	2.69%
2003	14.68%	7.33%	7.35%
2004	13.82%	6.68%	7.14%
2005	20.53%	5.85%	14.68%
2006	22.43%	5.54%	16.89%
2007	25.35%	5.17%	20.18%
2008	19.28%	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%
4 years 6 months to 30 June 2016	14.37%	5.86%	8.52%

ANNUALISED TO 30 JUNE 2016	CORONATION BALANCED PLUS	AVERAGE COMPETITOR	ALPHA
1 year	4.25%	5.26%	(1.01%)
3 years	11.29%	10.54%	0.76%
5 years	13.83%	11.46%	2.37%
10 years	13.02%	10.13%	2.89%
Since inception in April 1996 annualised	15.75%	13.29%	2.46%
Average 5-year real return			9.52%
Number of 5-year periods where the real return is >10%			7.00
Number of 5-year periods where the real return is between 5% – 10%			7.00
Number of 5-year periods where the real return is between 0% – 5%			3.00

CUMULATIVE PERFORMANCE



ANNUALISED RETURNS TO 30 JUNE 2016



An investment of R100 000 in Coronation Balanced Plus fund on 30 April 1996 would have grown to **R1 910 343** by 30 June 2016 . By comparison, the mean return of the South African Multi Asset High Equity sector over the same period would have grown a similar investment to **R1 238 849**.

† *Average competitor return is the mean of the South African Multi-Asset High Equity sector.*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